

Filing Date: 3/22/2005 Form Type: 10KSB

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Washington, D.C. 20549

FORM 10-KSB× **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2004

OR

· **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number 1-5735

Union Financial Bancshares, Inc.

(Name of small business issuer in its charter)

Delaware
(State or other jurisdiction of incorporation
or organization)**57-1001177**
(I.R.S. Employer
Identification No.)**203 West Main Street, Union, South Carolina**
(Address of principal executive offices)**29379**
(Zip Code)**Issuer's telephone number: (864) 429-1864****Securities registered pursuant to Section 12(b) of the Exchange Act: None****Securities registered pursuant to Section 12(g) of the Exchange Act:****Common stock, par value \$.01 per share**
(Title of Class)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes

× No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of the registrant's knowledge, in definitive proxy or other information statements incorporated by reference in Part III of this Form 10-KSB or any amendments to this Form 10-KSB. ×

The issuer's revenues for the fiscal year ended December 31, 2004 were approximately \$19,535,000.

As of February 25, 2005, there were 1,915,827 shares of the registrant's common stock issued and outstanding. The aggregate market value of the voting stock held by non-affiliates, computed by reference to the average bid and asked price on March 4, 2005, was approximately \$30,876,963 (1,724,970 shares at \$17.90 per share). Solely for the purposes of this calculation it is assumed that directors and executive officers are affiliates of the registrant.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the Annual Report to Shareholders for the Fiscal Year Ended December 31, 2004 (Part II).
2. Portions of the Proxy Statement for the 2005 Annual Meeting of Shareholders (Part III).

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PART I

Item 1. Business

General

Union Financial Bancshares, Inc. (“Union Financial”) is the bank holding company for Provident Community Bank, N.A. (the “Bank”). Union Financial has no material assets or liabilities other than its investment in the Bank. Union Financial’s business activity consists primarily of directing the activities of the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to the Bank. Union Financial and the Bank are collectively referred to as “the Corporation” herein.

The Bank converted from a federal savings bank to a national bank charter in July 2003. The Bank’s operations are conducted through its main office in Union, South Carolina and six full-service banking centers, all of which are located in the upstate area of South Carolina. The Bank is regulated by the Office of the Comptroller of the Currency (the “OCC”), is a member of the Federal Home Loan Bank of Atlanta (the “FHLB”) and its deposits are insured up to applicable limits by the Federal Deposit Insurance Corporation (the “FDIC”). In addition, Union Financial is a bank holding company, subject to regulation by the Federal Reserve Board (the “FRB”).

On October 21, 2003, the Board of Directors of Union Financial changed the fiscal year end of the Corporation from September 30 to December 31, effective December 31, 2003.

The business of the Bank consists primarily of attracting deposits from the general public and originating loans to consumers and businesses. The Bank also maintains a portfolio of investment securities. The principal sources of funds for the Bank’s lending activities include deposits received from the general public, interest and principal repayments on loans and, to a lesser extent, borrowings from the FHLB. The Bank’s primary source of income is interest earned on loans and investments. The Bank’s principal expense is interest paid on deposit accounts and borrowings and expenses incurred in operating the Bank.

This annual report contains certain “forward-looking statements” within the meaning of the federal securities laws. These forward-looking statements are generally identified by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project” or similar expressions. These forward-looking statements include, but are not limited to, estimates and expectations of future performance with respect to the financial condition and results of operations of the Corporation and other factors. These forward-looking statements are not guarantees of future performance and are subject to various factors that could cause actual results to differ materially from these forward-looking statements. These factors include, but are not limited to: changes in general economic and market conditions and the legal and regulatory environment in which the Corporation operates; the development of an interest rate environment that adversely affects the Corporation’s interest rate spread or other income anticipated from the Corporation’s operations; changes in consumer spending, borrowing and savings habits; adverse changes in the securities markets; changes in accounting policies and practices; and increased competitive pressures among financial services companies. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. The Corporation does not undertake—and specifically disclaims any obligation—to publicly release the results of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

Competition

The Bank faces competition in both the attraction of deposit accounts and in the origination of mortgage, commercial and consumer loans. Its most direct competition for savings deposits has historically been derived from other thrift institutions and commercial banks located in and around Union, Laurens, Fairfield and York Counties, South Carolina. As of June 30, 2004, according to information presented on the Federal Deposit Insurance Corporation’s website, the Corporation held 44% of the deposits in Union County, which was the largest share of deposits out of four financial institutions in the county. Additionally, the Corporation held 24% of the deposits in Fairfield County, which was the second largest out of four financial institutions in the county and 8% of the deposits in Laurens County, which was the sixth largest share of deposits out of eight financial institutions in the county.

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However, the Corporation competes with super-regional banks, such as Wachovia Bank and National Bank of Commerce, and large regional banks, such as First-Citizens Bank and Trust Company of South Carolina and Carolina First Bank. These competitors have substantially greater resources and lending limits than the Corporation does and offers services that the Corporation does not provide. The Bank faces additional significant competition for investor funds from money market instruments and mutual funds. It competes for savings by offering depositors a variety of savings accounts, convenient office locations and other services.

The Bank competes for loans principally through the interest rates and loan fees it charges and the efficiency and quality of the services it provides borrowers, real estate brokers and home builders. The Bank's competition for real estate loans comes principally from other thrift institutions, commercial banks and mortgage banking companies.

Competition has increased and is likely to continue to increase as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. Technological advances, for example, have lowered barriers to market entry, allowed banks to expand their geographic reach by providing services over the Internet and made it possible for non-depository institutions to offer products and services that traditionally have been provided by banks. The Gramm-Leach-Bliley Act, which permits affiliation among banks, securities firms and insurance companies, also has changed and may continue to change the competitive environment in which the Bank conducts business.

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The following table sets forth certain information for the periods indicated regarding: (1) average balances of assets and liabilities; (2) the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities; and (3) average yields and costs. Such yields and costs for the periods indicated are derived by dividing income or expense by the average monthly balance of assets or liabilities, respectively, for the periods presented.

| | Year Ended December 31, | | | Year Ended September 30, | | | | | |
|--|-------------------------|-----------|--------------------|--------------------------|-----------|--------------------|-----------------|-----------|--------------------|
| | 2004 | | | 2003 | | | 2002 | | |
| | Average Balance | Interest | Average Yield/Cost | Average Balance | Interest | Average Yield/Cost | Average Balance | Interest | Average Yield/Cost |
| (Dollars in thousands) | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Loans receivable, net (1) | \$ 160,131 | \$ 10,399 | 6.49% | \$ 157,265 | \$ 10,914 | 6.94% | \$ 165,085 | \$ 12,519 | 7.58% |
| Mortgage-backed securities | 48,216 | 1,868 | 3.93 | 79,104 | 2,991 | 3.78 | 73,397 | 4,012 | 5.47 |
| Investment securities: | | | | | | | | | |
| Taxable | 91,630 | 3,715 | 4.02 | 52,459 | 2,115 | 4.03 | 14,606 | 1,015 | 6.95 |
| Nontaxable | 21,063 | 930 | 4.57 | 18,490 | 881 | 4.77 | 17,648 | 731 | 4.14 |
| Total investment securities | 112,693 | 4,645 | 4.12 | 70,949 | 2,996 | 4.22 | 32,254 | 1,746 | 5.41 |
| Overnight deposits | 6,434 | 40 | 0.62 | 5,396 | 23 | 0.42 | 8,246 | 86 | 1.03 |
| Total interest-earning assets | 327,474 | 16,952 | 5.18 | 312,714 | 16,924 | 5.41 | 278,982 | 18,362 | 6.58 |
| Non-interest-earning assets | 24,803 | | | 22,630 | | | 18,365 | | |
| Total assets | \$ 352,277 | | | \$ 335,344 | | | \$ 297,347 | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Savings accounts | 17,966 | 72 | 0.40 | 15,639 | 116 | 0.75 | 15,336 | 146 | 0.95 |
| Negotiable order of withdrawal accounts | 58,060 | 436 | 0.75 | 42,348 | 277 | 0.65 | 37,862 | 425 | 1.12 |
| 3 Certificate accounts | 144,930 | 3,395 | 2.34 | 149,355 | 4,267 | 2.86 | 142,953 | 5,430 | 3.80 |
| FHLB advances and other borrowings | 103,639 | 3,343 | 3.23 | 97,900 | 4,042 | 4.13 | 74,918 | 3,774 | 5.04 |
| Total interest-bearing liabilities | 324,595 | 7,246 | 2.23 | 305,242 | 8,702 | 2.85 | 271,069 | 9,775 | 3.61 |
| Non-interest-bearing liabilities | 2,077 | | | 5,400 | | | 1,576 | | |
| Total liabilities | 326,672 | | | 310,642 | | | 272,645 | | |
| Shareholders' equity | 25,605 | | | 24,702 | | | 24,702 | | |
| Total liabilities and shareholders' equity | \$ 352,277 | | | \$ 335,344 | | | \$ 297,347 | | |
| Net interest income | | \$ 9,706 | | | \$ 8,222 | | | \$ 8,587 | |

| | | | | | | |
|--|--|-------|--|-------|--|-------|
| Interest rate spread (2) | | 2.94% | | 2.56% | | 2.97% |
| Net interest margin (3) | | 2.96% | | 2.63% | | 3.08% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | 1.01x | | 1.02x | | 1.03x |

- (1) Average loans receivable includes nonaccruing loans. Interest income does not include interest on loans 90 days or more past due.
- (2) Represents difference between weighted average yield on all interest-earning assets and weighted average rate on all interest-bearing liabilities.
- (3) Represents net interest income before provision for loan losses as a percentage of average interest-earning assets.

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General. Set forth below is selected data relating to the composition of the Bank's loan portfolio on the dates indicated (dollars in thousands).

| | At December 31, | | | | At September 30, | | | | | | |
|-------------------------------------|-------------------|----------------|-------------------|----------------|-------------------|----------------|-------------------|----------------|-------------------|----------------|--|
| | 2004 | | 2003 | | 2002 | | 2001 | | 2000 | | |
| | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | |
| First mortgage loans: | | | | | | | | | | | |
| Conventional | \$ 43,556 | 25.46% | \$ 55,647 | 36.39% | \$ 88,746 | 54.92% | \$ 110,109 | 69.66% | \$ 126,949 | 75.65% | |
| Commercial | 43,351 | 25.34 | 40,372 | 26.40 | 31,465 | 19.48 | 16,299 | 10.31 | 13,036 | 7.77 | |
| Multi-family and construction loans | 3,823 | 2.23 | 2,170 | 1.42 | 5,514 | 3.41 | 12,259 | 7.76 | 12,335 | 7.35 | |
| Total mortgage loans | 90,730 | 53.03 | 98,189 | 64.21 | 125,725 | 77.81 | 138,667 | 87.73 | 152,320 | 90.77 | |
| Consumer and installment loans | 30,826 | 18.02 | 25,445 | 16.64 | 25,884 | 16.02 | 22,662 | 14.33 | 22,307 | 13.29 | |
| Commercial loans | 54,796 | 32.02 | 33,859 | 22.14 | 16,100 | 9.96 | 5,593 | 3.54 | 2,527 | 1.51 | |
| Total loans | 176,352 | 103.07 | 157,493 | 102.99 | 167,709 | 103.79 | 166,922 | 105.60 | 177,154 | 105.57 | |
| Less: | | | | | | | | | | | |
| Undisbursed loans in process | (2,363) | (1.38) | (1,392) | (0.91) | (3,204) | (1.97) | (6,108) | (3.86) | (5,445) | (3.24) | |
| Loan discount unamortized | (993) | (0.58) | (1,448) | (0.95) | (1,685) | (1.04) | (1,922) | (1.22) | (2,718) | (1.62) | |
| Allowance for loan losses | (2,026) | (1.18) | (1,842) | (1.20) | (1,371) | (0.85) | (1,080) | (0.68) | (1,360) | (0.81) | |
| Deferred loan fees | 124 | 0.07 | 110 | 0.07 | 127 | 0.07 | 251 | 0.16 | 176 | 0.10 | |
| Net loans receivable | \$ 171,094 | 100.00% | \$ 152,921 | 100.00% | \$ 161,576 | 100.00% | \$ 158,063 | 100.00% | \$ 167,807 | 100.00% | |

The following table sets forth, at December 31, 2004, certain information regarding the dollar amount of principal repayments for loans becoming due during the periods indicated (in thousands). Demand loans (loans having no stated schedule of repayments and no stated maturity) and overdrafts are reported as due in one year or less.

| | Due Within One Year | Due After 1 Year Through 5 Years | Due After 5 Years | Total |
|---|---------------------|----------------------------------|-------------------|-----------|
| First mortgage loans: | | | | |
| Conventional loans | \$ 207 | \$ 2,257 | \$ 41,092 | \$ 43,556 |
| Commercial loans | 10,300 | 29,168 | 3,883 | 43,351 |
| Multi-family and construction loans (1) | 3,823 | — | — | 3,823 |

| | | | | |
|--------------------------------|------------------|------------------|------------------|-------------------|
| Consumer and installment loans | 3,129 | 9,875 | 17,822 | 30,826 |
| Commercial loans | 19,696 | 26,057 | 9,043 | 54,796 |
| Total | <u>\$ 37,155</u> | <u>\$ 67,357</u> | <u>\$ 71,840</u> | <u>\$ 176,352</u> |

(1) Includes construction/permanent loans.

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The actual average life of mortgage loans is substantially less than their contractual term because of loan repayments and because of enforcement of due-on-sale clauses that give the Bank the right to declare a loan immediately due and payable if, among other things, the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase, however, when current mortgage loan rates substantially exceed rates on existing mortgage loans.

The following table sets forth, at December 31, 2004, the dollar amount of loans due after December 31, 2005 which have fixed rates of interest and which have adjustable rates of interest (in thousands).

| | Fixed | Adjustable | Total |
|--------------------------------|------------------|------------------|-------------------|
| First mortgage loans: | | | |
| Conventional loans | \$ 27,800 | \$ 15,549 | \$ 43,349 |
| Commercial loans | 9,688 | 23,363 | 33,051 |
| Consumer and installment loans | 12,559 | 15,138 | 27,697 |
| Commercial loans | 6,218 | 28,882 | 35,100 |
| Total | \$ 56,265 | \$ 82,932 | \$ 139,197 |

Real Estate Loans. The Bank originates conventional mortgage loans to enable borrowers to purchase existing single family homes or to construct new homes. The Bank's residential real estate loan portfolio also includes loans on multi-family dwellings (more than five units) and commercial real estate. At December 31, 2004, approximately \$43.5 million, or 25.5% of the Corporation's net loan portfolio consisted of loans secured by residential real estate (net of undisbursed principal, excluding construction loans).

Office of the Comptroller of the Currency regulations limit the amount that national banks may lend in relationship to the appraised value of the real estate securing the loan, as determined by an appraisal at the time of loan origination. Federal regulations permit a maximum loan-to-value ratio of 100% for one-to four-family dwellings and 85% for all other real estate loans. The Bank's lending policies, however, limit the maximum loan-to-value ratio on one-to-four-family real estate mortgage loans to 80% of the lesser of the appraised value or the purchase price. Any single-family loan made in excess of an 80% loan-to-value ratio and any commercial real estate loan in excess of a 75% loan-to-value ratio is required to have private mortgage insurance or additional collateral. In the past, the Bank has originated some commercial real estate loans in excess of a 75% loan-to-value ratio without private mortgage insurance or additional collateral.

The loan-to-value ratio, maturity and other provisions of the loans made by the Bank have generally reflected a policy of making less than the maximum loan permissible under applicable regulations, market conditions, and underwriting standards established by the Bank. Mortgage loans made by the Bank are generally long-term loans (15-30 years), amortized on a monthly basis, with principal and interest due each month. In the Bank's experience, real estate loans remain outstanding for significantly shorter periods than their contractual terms. Borrowers may refinance or prepay loans, at their option, with no prepayment penalty.

The Bank offers a full complement of mortgage lending products with both fixed and adjustable rates. Due to the nature of the Bank's marketplace, only a small percentage of "local" loans are adjustable-rate mortgage loans ("ARMs"). The majority of adjustable-rate loans in the portfolio are originated outside of the Bank's market area by third party originators. These loans are originated and underwritten using the same terms and conditions as loans originated by the Bank. The Bank offers ARMs tied to U.S. Treasury Bills with a maximum interest rate adjustment

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of 2% annually and 6% over the life of the loan. At December 31, 2004, the Bank had approximately \$15.5 million of ARMs, or 9.1% of the Bank's total loans receivable. At December 31, 2004, 16.4% of the Bank's loan portfolio consisted of long-term, fixed-rate real estate loans.

Net interest income depends to a large extent on how successful the Corporation is in "matching" interest-earning assets and interest-bearing liabilities. The Corporation has taken steps to reduce its exposure to rising interest rates. For a discussion of these steps, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Annual Report.

Commercial real estate loans constituted approximately \$43.4 million, or 25.3%, of the Bank's net loan portfolio at December 31, 2004. Commercial real estate loans consist of permanent loans secured by multi-family loans, generally apartment houses, as well as commercial and industrial properties, including office buildings, warehouses, shopping centers, hotels, motels and other special purpose properties. Commercial real estate loans are originated and purchased for inclusion in the Bank's portfolio. These loans generally have 20- to 30-year amortization schedules and are callable or have balloon payments after five years. Typically, the loan documents provide for adjustment of the interest rate every one to three years. Fixed-rate loans secured by multi-family residential and commercial properties have terms ranging from 20 to 25 years.

Loans secured by multi-family and commercial real estate properties may involve greater risk than single-family residential loans. Such loans generally are substantially larger than single-family residential loans. Further, the payment experience on loans secured by commercial properties typically depends on the successful operation of the properties, and thus may be subject to a greater extent to adverse conditions in the real estate market or in the economy generally.

Construction Loans. The Bank engages in construction lending that is primarily secured by single family residential real estate and, to a much lesser extent, commercial real estate. The Bank grants construction loans to individuals with a takeout for permanent financing from another financial institution, and to approved builders on both presold and unsold properties.

Loan brokers are the Bank's primary source for construction loans. The loan broker sends the Bank both individuals seeking construction financing for their personal dwelling or builders seeking lines of credit for the construction of single family residences on both presold and unsold properties. Construction loans to individuals are originated for a term of one year or less or are originated to convert to permanent loans at the end of the construction period. Construction loans are originated to builders for a term not to exceed 12 months. Generally, draw inspections are handled by the appraiser who initially appraised the property; however, in some instances the draw inspections are performed by the originating brokerage firm.

Construction financing affords the Bank the opportunity to achieve higher interest rates and fees with shorter terms to maturity than do single-family permanent mortgage loans. However, construction loans are generally considered to involve a higher degree of risk than single-family permanent mortgage lending due to: (1) the concentration of principal among relatively few borrowers and development projects; (2) the increased difficulty at the time the loan is made of estimating the building costs and the selling price of the property to be built; (3) the increased difficulty and costs of monitoring the loan; (4) the higher degree of sensitivity to increases in market rates of interest; and (5) the increased difficulty of working out loan problems.

At December 31, 2004, the Bank had approximately \$3.8 million outstanding in construction loans, including approximately \$2.4 million in undisbursed proceeds. Substantially all of these loans were secured by one- to four-family residences.

Consumer Loans . The Bank's consumer loan portfolio consists primarily of automobile loans on new and used vehicles, mobile home loans, boat loans, second mortgage loans, loans secured by savings accounts and unsecured loans. The Bank makes consumer loans to serve the needs of its customers and as a way to improve the interest-rate sensitivity of the Bank's loan portfolio.

Consumer loans tend to bear higher rates of interest and have shorter terms to maturity than residential mortgage loans. However, nationally, consumer loans have historically tended to have a higher rate of default than

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residential mortgage loans. Additionally, consumer loans entail greater risk than do residential mortgage loans, particularly in the case of loans that are unsecured or secured by rapidly depreciating assets such as automobiles. In these cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

Commercial Loans. The Bank makes commercial business loans primarily in its market area through its branch network to small businesses. Each county location of the branch network has an experienced commercial lender that is responsible for the generation of this product. In selective cases, the Bank will enter into a loan participation within its market area to purchase a portion of a commercial loans that meets the Banks underwriting criteria. The Bank offers secured commercial loans with maturities of up to 20 years. The term for repayment will normally be limited to the lesser of the expected useful life of the asset being financed or a fixed amount of time, generally less than seven years. These loans have adjustable rates of interest indexed to the prime rate as reported in *The Wall Street Journal* and are payable on demand, subject to annual review and renewal. When making commercial loans, the Bank considers the financial statements of the borrower, the borrower's payment history of both corporate and personal debt, the debt service capabilities of the borrower, the projected cash flows of the business, the viability of the industry in which the customer operates and the value of the collateral. Commercial loans are generally secured by a variety of collateral, primarily accounts receivable, inventory and equipment, and are generally supported by personal guarantees. Depending on the collateral used to secure the loans, commercial loans are made in amounts of up to 80% of the value of the collateral securing the loan. The Bank's largest commercial loan relationship was a \$3.2 million loan secured by real estate located in Rock Hill, South Carolina. This loan was performing according to its original terms at December 31, 2004.

Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income, and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. Further, any collateral securing such loans may depreciate over time, may be difficult to appraise and may fluctuate in value.

Loan Solicitation and Processing. Loan originations come from both walk-in customers and loan brokers. The loan origination process for walk-in customers includes an initial interview with an officer of the Bank for the purpose of obtaining a formal application. Upon receipt of a loan application from a prospective borrower, a credit report is ordered to verify specific information relating to the loan applicant's employment, income and credit standing. This information may be further verified by personal contacts with other reference sources. An appraisal of the real estate intended to secure the proposed loan is undertaken by pre-approved, independent fee appraisers. As soon as the required information has been obtained and the appraisal completed, the loan is submitted to the authorized officer, loan committees or full Board of Directors for review. The Bank utilizes various officers and loan committees for the approval of real estate loans. The President and Chief Executive Officer has the authority to approve loan requests up to and including \$500,000 in secured credit and up to and including \$500,000 in unsecured credit. The President and Chief Executive Officer or the Chief Credit Officer along with two members of the Board Loan Committee have the authority to approve loan requests up to \$1,000,000 in secured credit and \$500,000 in unsecured credit. The Board of Directors has appointed a Board Loan Committee comprised of two members elected annually from the Board of Directors and four senior executive officers of the Bank. A quorum of three members, including at least one Board member, is required for any action. This Committee has the authority to approve all secured and unsecured loan requests with the exception of a single loan request exceeding \$2,000,000 in secured credit and exceeding \$1,000,000 in unsecured credit, which require approval of the entire Board of Directors.

Loan applicants are promptly notified of the decision of the Bank by telephone, setting forth the terms and conditions of the decision. If approved, these terms and conditions include the amount of the loan, interest rate, amortization term, and a brief description of the real estate to be mortgaged to the Bank. The Bank also issues a commitment letter to the potential borrower which typically remains in effect for 60 days. The Bank's experience is that very few commitments go unfunded. See "Loan Commitments." The borrower is required to pay all origination costs incurred in connection with the particular loan closing.

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Loan Originations, Purchases and Sales. During fiscal 2001, the Bank reduced broker loan purchases and originations and phased out its mortgage lending operations to provide an increased capital allocation for consumer and commercial lending. Consequently, the Bank did not securitize any loans in either the 2004 or 2003 fiscal years. The Bank does not have any current plans to sell a large volume of loans, other than fixed-rate mortgage loans it originates through its retail branch network. The Bank purchases participation interests in loans originated by other institutions. The Bank had total purchases of participation interests of \$7.8 million in fiscal 2004. These participation interests are on both residential and commercial properties and carry either a fixed or adjustable interest rate. The Bank performs its own underwriting analysis on each of its participation interests before purchasing such loans and therefore believe there is no greater risk of default on these obligations. However, in a purchased participation loan, the Bank does not service the loan and thus are subject to the policies and practices of the lead lender with regard to monitoring delinquencies, pursuing collections and instituting foreclosure proceedings. The Bank is permitted to review all of the documentation relating to any loan in which the Bank participates, including any annual financial statements provided by a borrower. Additionally, the Bank receives periodic updates on the loan from the lead lender.

The following table sets forth the Bank's loan origination activity for the periods indicated (in thousands):

| | Year Ended December 31, 2004 | Year Ended September 30, | |
|-------------------------------------|------------------------------------|-----------------------------|-----------|
| | | 2003 | 2002 |
| Loans originated: | | | |
| First mortgage loans: | | | |
| Conventional loans | \$ 6,025 | \$ 7,590 | \$ 9,926 |
| Multi-family and construction loans | 1,411 | 2,550 | 6,625 |
| Total mortgage loans originated | 7,436 | 10,140 | 16,551 |
| Consumer and installment loans | 15,166 | 11,172 | 12,318 |
| Commercial loans | 43,121 | 41,229 | 57,838 |
| Total loans originated | \$ 65,723 | \$ 62,541 | \$ 86,707 |
| Loan participations | \$ 7,798 | \$ 7,085 | \$ 5,275 |

Loan Commitments. The Bank's commitments to make conventional mortgage and commercial loans are normally made for periods of up to 60 days from the date of loan approval. See "Financial Condition, Liquidity and Capital Resources" in the Annual Report.

Loan Origination and Other Fees. In addition to interest earned on loans and fees for making loan commitments, the Bank charges origination fees or "points" for originating loans. Loan origination fees are usually a percentage of the principal amount of the mortgage loan, typically between 0.5% and 2%, depending on the terms and conditions. Other fees collected include late charges applied to delinquent payments and fees collected in connection with loan modifications. The Bank charges a 5% late charge fee on payments delinquent 15 days or more on new loan originations, loan modifications, loan assumptions and loans currently in the Bank's portfolio where applicable. Late charges and modification fees do not constitute a material source of income. Accounting standards require fees received (net of certain loan origination costs) for originating loans to be deferred and amortized into interest income over the contractual life of the loan. As of December 31, 2004, the Corporation had net deferred loan fees of approximately \$124,000.

Problem Assets. When a borrower fails to make a required payment on a loan, the Bank attempts to cure the default by contacting the borrower. In general, borrowers are contacted after a payment is more than 30 days past due. In most cases, defaults are cured promptly. If the delinquency on a mortgage loan is not cured through the Bank's normal collection procedures, or an acceptable arrangement is not worked out with the borrower, the Bank will institute measures to remedy the default, including commencing a foreclosure action.

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Loans are reviewed on a regular basis and an allowance for uncollectible interest is established against accrued interest receivable when, in the opinion of management, the collection of additional interest is doubtful. An allowance for uncollectible interest on real estate loans and consumer loans is established when either principal or interest is more than 90 days past due. Subsequent payments are either applied to the outstanding principal balance or recorded as interest income, depending on the assessment of the ultimate collectibility of the loan. See Notes 1 and 3 of Notes to Consolidated Financial Statements.

A loan is impaired when it is probable, based on current information, the Corporation will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Management has determined that, generally, a failure to make a payment within a 90-day period constitutes a minimum delay or shortfall and does not generally constitute an impaired loan. However, management reviews each past due loan on a loan-by-loan basis and may determine a loan to be impaired prior to the loan becoming over 90 days past due, depending upon the circumstances of that particular loan. A loan is classified as non-accrual at the time management believes that the collection of interest is improbable, generally when a loan becomes 90 days past due. The Bank's policy for charge-off of impaired loans is on a loan-by-loan basis. At the time management believes the collection of interest and principal is remote, the loan is charged off. The Bank's policy is to evaluate impaired loans based on the fair value of the collateral. Interest income from impaired loans is recorded using the cash method.

Real estate acquired by the Bank as a result of foreclosure or by deed in lieu of foreclosure is classified as real estate owned. When such property is acquired it is recorded at the lower of the unpaid principal balance of the related loan or its fair market value less selling costs. Any subsequent write-down of the property is charged to income.

The following table sets forth information with respect to the Bank's non-performing assets for the periods indicated (dollars in thousands). It is the policy of the Bank to cease accruing interest on loans 90 days or more past due. As of and for the years ended December 31, 2004 and September 30, 2003, \$197,000 and \$718,246, respectively, were classified within the meaning of Statement of Financial Accounting Standards ("SFAS") No. 15. The reduction in non-performing assets from \$3.7 million at September 30, 2003 to \$1.1 million at December 31, 2004 was due primarily to the increase in loan charge-offs of \$1.4 million for the comparable period.

| | At | At September 30, | | | |
|---|----------------------|------------------|-----------------|---------------|-----------------|
| | December 31, 2004 | 2003 | 2002 | 2001 | 2000 |
| Loans accounted for on a non-accrual basis: | | | | | |
| Real estate | \$ 217 | \$ 408 | \$ 916 | \$ 626 | \$ 763 |
| Commercial | 142 | 2,437 | 524 | 160 | 247 |
| Consumer | 391 | 209 | 426 | 9 | 106 |
| Total | 750 | 3,054 | 1,866 | 795 | 1,116 |
| Accruing loans which are contractually past due 90 days or more | — | — | — | — | — |
| Real estate owned, net | 364 | 652 | 356 | 77 | 459 |
| Total non-performing assets | \$ 1,114 | \$ 3,706 | \$ 2,222 | \$ 872 | \$ 1,575 |
| Percentage of non-performing assets to loans receivable net | 0.65% | 2.42% | 1.37% | 0.56% | 0.94% |

Interest income that would have been recorded for the year ended December 31, 2004 had non-accruing loans been current in accordance with their original terms amounted to approximately \$45,000. There was no interest included in interest income on such loans for the year ended December 31, 2004.

Allowance for Loan Losses. In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the security for the loan. To cover losses inherent in the portfolio of performing loans, the Bank maintains an allowance for loan losses. Management's periodic evaluation of the adequacy of the allowance is based on a number of factors,

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including management's evaluation of the collectibility of the loan portfolio, the nature and size of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans and economic conditions. The amount of the allowance is based on the estimated value of the collateral securing the loan and other analysis pertinent to each situation.

The Bank increases its allowance for loan losses by charging provisions for loan losses against income. The allowance for loan losses is maintained at an amount management considers adequate to absorb losses inherent in the portfolio. Although management believes that it uses the best information available to make such determinations, future adjustments to the allowance for loan losses may be necessary and results of operations could be significantly and adversely affected if circumstances differ substantially from the assumptions used in making the determinations.

The provision for loan loss calculation includes a segmentation of loan categories subdivided by residential mortgage, commercial and consumer loans. Each category is rated for all loans including performing groups. The weights assigned to each performing group is developed from previous loan loss experience and as the loss experience changes, the category weight is adjusted accordingly. In addition, as the amount of loans in each category increases and decreases, the provision for loan loss calculation adjusts accordingly.

While the Bank believes it has established its existing allowance for loan losses in accordance with generally accepted accounting principles, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to significantly increase its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses will adversely affect the Corporation's financial condition and results of operations. See Notes 1 and 3 of Notes to Consolidated Financial Statements for information concerning the Bank's provision and allowance for possible loan losses.

The following table sets forth an analysis of the Bank's allowance for loan losses for the periods indicated (dollars in thousands):

| | At December 31, 2004 | Three Months Ended December 31, 2003 | At September 30, | | | |
|--|----------------------------|---|------------------|----------|----------|----------|
| | | | 2003 | 2002 | 2001 | 2000 |
| Balance at beginning of year | \$ 2,383 | \$ 1,842 | \$ 1,371 | \$ 1,080 | \$ 1,360 | \$ 836 |
| Loans charged off: | | | | | | |
| Real estate | (62) | (47) | (255) | (127) | (180) | (85) |
| Commercial | (1,740) | (154) | (11) | (542) | (211) | — |
| Consumer | (40) | (39) | (65) | (82) | (176) | (129) |
| Total charge-offs | (1,842) | (240) | (331) | (751) | (567) | (214) |
| Recoveries: | | | | | | |
| Real estate | 22 | 1 | 31 | 36 | 4 | — |
| Commercial | 192 | 51 | 6 | — | 8 | — |
| Consumer | 21 | 4 | 40 | 16 | 35 | 64 |
| Total recoveries | 235 | 56 | 77 | 52 | 47 | 64 |
| Net charge-offs | (1,607) | (184) | (254) | (699) | (520) | (150) |
| Merger additions | — | — | — | — | — | 449 |
| Provision for loan losses (1) | 1,250 | 725 | 725 | 990 | 240 | 225 |
| Balance at end of year | \$ 2,026 | \$ 2,383 | \$ 1,842 | \$ 1,371 | \$ 1,080 | \$ 1,360 |
| Ratio of net charge-offs to average gross loans outstanding during the period | 0.91% | 0.12% | 0.16% | 0.42% | 0.32% | 0.08% |

(1) See "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Annual Report for a discussion of the factors responsible for changes in the provision for loan losses between the periods.

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The Bank experienced bad debt charge-offs, net of recoveries, of approximately \$1.6 million in fiscal 2004 compared to \$254,000 for fiscal 2003. The loan charge-offs for the current year included approximately \$1.3 million from three commercial loans that were charged-off after the loans were determined to be uncollectable. The Bank does not think that the higher level of loan charge-offs for the current year reflects any trends in the commercial loan portfolio. The allowance for loan losses to total loans ratio at the end of fiscal 2004 was 1.18% compared to 1.19% at the end of fiscal 2003. Nonperforming assets, which includes repossessed assets and loans on non-accrual, decreased to \$1.1 million at December 31, 2004 from \$3.7 million at September 30, 2003.

The following table sets forth the breakdown of the allowance for loan losses by loan category and the percentage of loans in each category to total loans for the periods indicated. Management believes that the allowance can be allocated by category only on an approximate basis. The allocation of the allowance to each category is not necessarily indicative of further losses and does not restrict the use of the allowance to absorb losses in any category (dollars in thousands):

| | At December 31, 2004 | | At September 30, | | | | | | | |
|--|-------------------------|---|------------------|---|-----------------|---|-----------------|---|-----------------|--|
| | | | 2003 | | 2002 | | 2001 | | 2000 | |
| | Amount | % of Loans in Each Category to Total Loans | Amount | % of Loans in Each Category to Total Loans | Amount | % of Loans in Each Category to Total Loans | Amount | % of Loans in Each Category to Total Loans | Amount | % of Loans in Each Category to Total Loans |
| Real estate | \$ 208 | 26.87% | \$ 339 | 43.45% | \$ 357 | 62.58% | \$ 400 | 73.31% | \$ 600 | 78.62% |
| Commercial | 1,584 | 55.65 | 1,182 | 37.05 | 778 | 20.82 | 100 | 13.11 | 200 | 8.79 |
| Consumer | 121 | 17.48 | 209 | 19.50 | 141 | 16.60 | 500 | 13.58 | 500 | 12.59 |
| Unallocated | 113 | N/A | 112 | N/A | 95 | N/A | 80 | N/A | 60 | N/A |
| Total allowance for loan losses | \$ 2,026 | 100.00% | \$ 1,842 | 100.00% | \$ 1,371 | 100.00% | \$ 1,080 | 100.00% | \$ 1,360 | 100.00% |

The Bank adjusts balances on real estate acquired in settlement of loans to the lower of cost or market based on appraised value when the property is received in settlement. These values reflect current market conditions and sales experience. See Notes 1 and 3 of Notes to Consolidated Financial Statements.

Asset Classification . The Office of the Comptroller of the Currency requires national banks to classify problem assets. The Bank classifies its problem assets as “substandard,” “doubtful” or “loss,” depending on the presence of certain characteristics. An asset is considered “substandard” if it is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. “Substandard” assets include those characterized by the “distinct possibility” that the institution will sustain some loss if the deficiencies are not corrected. Assets classified as “doubtful” have all of the weaknesses inherent in those classified as “substandard” with the added characteristic that the weaknesses present make “collection or liquidation in full,” on the basis of currently existing facts, conditions, and values, “highly questionable and improbable.” Assets classified as “loss” are those considered “uncollectible” and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not currently expose the insured institution to sufficient risk to warrant classification in the above-mentioned categories but possess weaknesses are designated “special mention.”

When an institution classifies problem assets as either substandard or doubtful, it is required to establish general allowances for loan losses in an amount deemed prudent by management. General allowances represent loss allowances that have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an institution classifies problem assets or a portion of assets as loss, it is required either to establish a specific allowance for losses equal to

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100% of the amount of the asset or a portion thereof so classified or to charge-off such amount. An institution's determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the Comptroller of the Currency who can order the establishment of additional general or specific loss allowances.

The following tables set forth the number and amount of classified loans at December 31, 2004 (dollars in thousands):

| | Loss | | Doubtful | | Substandard | | Special Mention | |
|--------------|----------|-------------|----------|-------------|-------------|-----------------|-----------------|-----------------|
| | Number | Amount | Number | Amount | Number | Amount | Number | Amount |
| Real estate | — | \$ — | — | \$ — | 5 | \$ 217 | 10 | \$ 616 |
| Commercial | — | — | — | — | 7 | 3,528 | 6 | 2,118 |
| Consumer | — | — | — | — | 7 | 391 | 2 | 54 |
| Total | — | \$ — | — | \$ — | 19 | \$ 4,136 | 18 | \$ 2,788 |

[Table of Contents](#)**Investment Activities**

SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," requires that investments be categorized as "held to maturity," "trading securities" or "available for sale," based on management's intent as to the ultimate disposition of each security. SFAS No. 115 allows debt securities to be classified as "held to maturity" and reported in financial statements at amortized cost only if the reporting entity has the positive intent and ability to hold those securities to maturity. Securities that might be sold in response to changes in market interest rates, changes in the security's prepayment risk, increases in loan demand, or other similar factors cannot be classified as "held to maturity." Debt and equity securities held for current resale are classified as "trading securities." Such securities are reported at fair value, and unrealized gains and losses on such securities would be included in earnings. The Corporation currently does not use or maintain a trading account. Debt and equity securities not classified as either "held to maturity" or "trading securities" are classified as "available for sale." Such securities are reported at fair value, and unrealized gains and losses on such securities are excluded from earnings and reported as a net amount in a separate component of equity.

The following table sets forth the Corporation's investment and mortgage-backed securities portfolio at the dates indicated (dollars in thousands):

| | At December 31, 2004 | | At September 30, | | | |
|--|-------------------------|----------------------|------------------|----------------------|----------------|----------------------|
| | | | 2003 | | 2002 | |
| | Carrying Value | Percent of Portfolio | Carrying Value | Percent of Portfolio | Carrying Value | Percent of Portfolio |
| Available for sale: | | | | | | |
| Investment securities: | | | | | | |
| U.S. Agency obligations | \$ 71,548 | 50.43% | \$ 48,596 | 30.87% | \$ 10,599 | 9.01% |
| Corporate securities | 8,619 | 6.08 | 5,425 | 3.45 | 3,717 | 3.16 |
| Equity securities | 2,257 | 1.59 | 2,435 | 1.55 | — | — |
| Municipal securities | 20,544 | 14.48 | 22,334 | 14.18 | 14,597 | 12.41 |
| Total investment securities | 102,968 | 72.58 | 78,790 | 50.05 | 28,913 | 24.58 |
| Mortgage-backed and related securities | 38,896 | 27.42 | 78,648 | 49.95 | 88,720 | 75.42 |
| Total | \$ 141,864 | 100.00% | \$ 157,438 | 100.00% | \$ 117,633 | 100.00% |

| | At December 31, 2004 | | At September 30, | | | |
|--------------------------|-------------------------|----------------------|------------------|----------------------|----------------|----------------------|
| | | | 2003 | | 2002 | |
| | Carrying Value | Percent of Portfolio | Carrying Value | Percent of Portfolio | Carrying Value | Percent of Portfolio |
| Held to Maturity: | | | | | | |
| Investment securities: | | | | | | |
| Municipal securities | \$ 1,630 | 100.00 | — | — | — | — |
| Total | \$ 1,630 | 100.00% | — | — | — | — |

The Corporation purchases mortgage-backed securities, both fixed-rate and adjustable-rate, from Freddie Mac, Fannie Mae and Ginnie Mae with maturities from five to 30 years. The Corporation also purchases government agency adjustable-rate securities that are backed by the full faith and credit of the U.S. government. The Corporation increased its level of agency securities over the previous year to balance the portfolio mix and stabilize interest rate flows as a result of the high loan prepayment speeds experienced with mortgage-backed securities.

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The Corporation also purchases mortgage derivative securities in the form of collateralized mortgage obligations (“CMOs”). While these securities possess minimal credit risk due to the Federal guarantee backing the U.S. government agencies, they possess liquidity and interest rate risk. The amortized cost and fair value of the CMOs at December 31, 2004 was approximately \$7.2 million. See Note 2 of Notes to Consolidated Financial Statements for more information regarding investment and mortgage-backed securities.

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The following table sets forth at amortized cost (held to maturity) and market value (available for sale) the maturities and weighted average yields of the Corporation's investment and mortgage-backed securities portfolio at December 31, 2004 (dollars in thousands):

| | Amount Due or Repricing within: | | | | | | | | | |
|--|---------------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|----------------|------------------------|----------------|------------------------|
| | One Year or Less | | Over One to Five Years | | Over Five to Ten Years | | Over Ten Years | | Total | |
| | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield | Carrying Value | Weighted Average Yield |
| Available for Sale: | | | | | | | | | | |
| Investment securities: | | | | | | | | | | |
| U.S. Agency obligations | \$ 7,600 | 3.34% | \$ 49,938 | 4.23% | \$ 14,010 | 3.66% | — | — | \$ 71,548 | 4.02% |
| Municipal securities | 71 | 5.06 | 1,423 | 5.19 | 495 | 4.42 | 18,555 | 4.67 | 20,544 | 4.70 |
| Equity securities | — | — | — | — | — | — | 2,257 | 2.56 | 2,257 | 2.56 |
| Corporate securities | 2,171 | 5.02 | 4,460 | 4.64 | — | — | 1,988 | 7.00 | 8,619 | 5.28 |
| Total investment securities | 9,842 | 3.72 | 55,821 | 3.79 | 14,505 | 3.68 | 22,800 | 4.67 | \$ 102,968 | 4.23 |
| Mortgage-backed and related securities | 1,791 | 3.87 | 14,722 | 3.66 | 2,713 | 5.36 | 19,670 | 4.54 | 38,896 | 4.23 |
| Total available for sale | 11,633 | 3.74 | 70,543 | 3.76 | 17,218 | 3.95 | 42,470 | 4.61 | 141,864 | 4.23 |
| Held to Maturity: | | | | | | | | | | |
| Investment securities: | | | | | | | | | | |
| Municipal securities | — | — | — | — | — | — | 1,630 | 3.90 | 1,630 | 3.90 |
| Total held to maturity | \$ — | — | \$ — | — | \$ — | — | \$ 1,630 | 3.90 | \$ 1,630 | 3.90 |

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At December 31, 2004, approximately \$16.3 million of mortgage-backed securities were adjustable-rate securities.

Deposits and Borrowings

Deposits are the major source of the Corporation's funds for lending and other investment purposes. In addition to deposits, the Corporation derives funds from principal repayments and interest payments on loans and investment and mortgage-backed securities. Principal repayments and interest payments are a relatively stable source of funds, although principal prepayments tend to slow when interest rates increase. Deposit inflows and outflows may be significantly influenced by general market interest rates and money market conditions. During fiscal year 2004, the Bank experienced a net increase in deposits of approximately \$4.4 million due to the result of various deposit promotion programs with continued emphasis on increasing core deposits. In addition, the Bank also opened a new branch location during the third quarter of the fiscal year that contributed to the deposit growth. The Bank borrowed funds to support the remaining growth experienced in fiscal 2004.

Deposits . Local deposits are, and traditionally have been, the primary source of the Bank's funds for use in lending and for other general business purposes. The Bank offers a number of deposit accounts including NOW accounts, money market savings accounts, passbook and statement savings accounts, individual retirement accounts and certificate of deposit accounts. Deposit accounts vary as to terms regarding withdrawal provisions, deposit provisions and interest rates.

The Bank adjusts the interest rates offered on its deposit accounts as necessary so as to remain competitive with other financial institutions in Union, Laurens, York and Fairfield County.

The following table sets forth the time deposits of the Bank classified by rates as of the dates indicated (in thousands):

| | At December 31, 2004 | At September 30, | |
|-----------------------------------|-------------------------|-------------------|-------------------|
| | | 2003 | 2002 |
| Up to 2.0% | \$ 58,034 | \$ 73,282 | \$ 16,830 |
| 2.01% to 4.0% | 68,942 | 57,186 | 90,116 |
| 4.01% to 6.0% | 16,089 | 21,951 | 29,103 |
| 6.01% to 8.0% | 495 | 823 | 2,791 |
| Total savings certificates | \$ 143,560 | \$ 153,242 | \$ 138,840 |

The following table sets forth the maturities of time deposits at December 31, 2004 (in thousands):

| | Amount |
|--|-------------------|
| Within three months | \$ 23,362 |
| After three months but within six months | 28,527 |
| After six months but within one year | 40,445 |
| After one year but within three years | 48,544 |
| After three years but within five years | 2,085 |
| After five years but within ten years | 597 |
| Total | \$ 143,560 |

Certificates of deposit with maturities of less than one year decreased from \$103.6 million at September 30, 2003 to \$92.3 million at December 31, 2004. Historically, the Bank has been able to retain a significant amount of its deposits as they mature. In addition, management of the Bank believes that it can adjust the offering rates of savings certificates to retain deposits in changing interest rate environments.

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The following table indicates the amount of the Bank's jumbo certificates of deposit by time remaining until maturity as of December 31, 2004 (in thousands). Jumbo certificates of deposit are certificates in amounts of \$100,000 or more.

| <u>Maturity Period</u> | <u>Amount</u> |
|---------------------------------------|------------------|
| Three months or less | \$ 8,458 |
| Over three through six months | 10,325 |
| Over six months through twelve months | 14,632 |
| Over twelve months | 18,472 |
| Total jumbo certificates | \$ 51,887 |

See Note 6 of Notes to Consolidated Financial Statements for additional information about deposit accounts.

Borrowings. The Corporation utilizes advances from the FHLB agreements and other borrowings (treasury, tax and loan deposits, security repurchase agreements and trust preferred capital obligations) to supplement its supply of lendable funds for granting loans, making investments and meeting deposit withdrawal requirements. See "Regulation and Supervision — Federal Home Loan Bank System."

The following tables set forth certain information regarding borrowings by the Bank at the dates and for the periods indicated (dollars in thousands):

| | <u>At December 31,</u> <u>2004</u> | <u>At September 30,</u> | |
|---|---|---|-------------|
| | | <u>2003</u> | <u>2002</u> |
| Balance outstanding at end of period: | | | |
| FHLB advances and other borrowings | \$ 95,747 | \$ 93,000 | \$ 82,000 |
| Weighted average rate paid on: | | | |
| FHLB advances and other borrowings | 3.07% | 3.59% | 4.94% |
| | | | |
| | <u>Year Ended</u> <u>December 31,</u> <u>2004</u> | <u>Year Ended</u> <u>September 30,</u> | |
| | | <u>2003</u> | <u>2002</u> |
| Maximum amount of borrowings outstanding at any month end: | | | |
| FHLB advances and other borrowings | \$ 103,750 | \$ 104,000 | \$ 82,000 |
| Approximate average borrowings outstanding with respect to: | | | |
| FHLB advances and other borrowings | \$ 103,600 | 97,900 | 74,936 |
| Approximate weighted average rate paid on: | | | |
| FHLB advances and other borrowings | 3.23% | 4.13% | 5.04% |

At December 31, 2004, the Corporation had unused short-term lines of credit to purchase federal funds from unrelated banks totaling \$10 million. These lines of credit are available on a one-to-ten day basis for general purposes of the Corporation. All of the lenders have reserved the right to withdraw these lines at their option. At December 31, 2004, the Bank had unused lines of credit for longer term advances totaling \$11 million.

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Subsidiary Activities

Under OCC regulations, the Bank generally may invest in operating subsidiaries, which may engage in activities permissible for the Bank itself. The Bank currently holds Provident Financial Services, Inc. for the purpose of engaging in securities brokerage activities for the benefit of the Bank's customers.

Union Financial maintains one other subsidiary other than the Bank. In November 2001, Union Financial Statutory Trust I was established as a statutory trust under Connecticut law for the purpose of issuing trust preferred securities. Union Financial Statutory Trust I issued trust preferred securities on December 18, 2001.

Employees

The Corporation has 68 full-time employees and 11 part-time employees. None of the employees are represented by a collective bargaining unit. The Corporation believes that relations with its employees are excellent.

REGULATION AND SUPERVISION

General

Union Financial, which is a bank holding company, is required to file certain reports with the Federal Reserve Board and otherwise comply with the Bank Holding Company Act of 1956, as amended ("BHCA") and the rules and regulations promulgated thereunder.

The Bank, as a national bank, is subject to extensive regulation, examination and supervision by the Office of the Comptroller of the Currency, as its primary regulator, and the Federal Deposit Insurance Corporation, as the deposit insurer. The Bank's deposit accounts are insured up to applicable limits by the Savings Association Insurance Fund managed by the FDIC. The Bank must file reports with the OCC and the FDIC concerning its activities and financial condition in addition to obtaining regulatory approvals prior to entering into certain transactions such as mergers with, or acquisitions of, other institutions. The OCC and/or the FDIC conduct periodic examinations to test the Bank's safety and soundness and compliance with various regulatory requirements. Many aspects of the Bank's operations are regulated by federal law including allowable activities, reserves against deposits, branching, mergers and investments. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the insurance fund and depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulatory requirements and policies, whether by the OCC, the FDIC, or Congress, could have a material adverse impact on Union Financial or the Bank and their operations.

Certain regulatory requirements applicable to the Bank and Union Financial are referred to below or elsewhere herein. This description of statutory provisions and regulations applicable to national banks and their holding companies does not purport to be a complete description of such statutes and regulations and their effects on the Bank and Union Financial.

Holding Company Regulation

Federal Regulation. As a bank holding company, Union Financial is subject to examination, regulation and periodic reporting under the BHCA, as administered by the FRB. Union Financial is required to obtain the prior approval of the FRB to acquire all, or substantially all, of the assets of any bank or bank holding company or merge with another bank holding company. Prior FRB approval is also required for Union Financial to acquire direct or indirect ownership or control of any voting securities of any bank or bank holding company if, after giving effect to such acquisition, Union Financial would, directly or indirectly, own or control more than 5% of any class of voting shares of the bank or bank holding company. In evaluating such transactions, the FRB considers such matters as the financial and managerial resources of and future prospects of the companies and banks involved, competitive factors and the convenience and needs of the communities to be served. Bank holding companies may acquire additional banks in any state, subject to certain restrictions such as deposit concentration limits. In addition to the approval of the FRB, before any bank acquisition can be completed, prior approval may also be required from other agencies having supervisory jurisdiction over the banks to be acquired.

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A bank holding company is generally prohibited from engaging in, or acquiring direct or indirect control of more than 5% of the voting securities of any company conducting non-banking activities. One of the principal exceptions to this prohibition is for activities found by the FRB to be so closely related to banking or managing or controlling banks to be a proper incident thereto. Some of the principal activities that the FRB has determined by regulation to be closely related to banking are: (1) making or servicing loans; (2) performing certain data processing services; (3) providing discount brokerage services; (4) acting as fiduciary, investment or financial advisor; (5) finance leasing personal or real property; (6) making investments in corporations or projects designed primarily to promote community welfare; and (7) acquiring a savings association, provided that the savings association only engages in activities permitted by bank holding companies.

The Gramm-Leach-Bliley Act of 1999 authorizes a bank holding company that meets specified conditions, including being “well-capitalized” and “well managed,” to opt to become a “financial holding company” and thereby engage in a broader array of financial activities than previously permitted. Such activities may include insurance underwriting and investment banking. The Gramm-Leach-Bliley Act also authorizes banks to engage through “financial subsidiaries” in certain of the activities permitted for financial holding companies. Financial subsidiaries are generally treated as affiliates for purposes of restrictions on a bank’s transactions with affiliates.

The FRB has adopted capital adequacy guidelines for bank holding companies (on a consolidated basis) substantially similar to those of the OCC for the Bank. See “Capital Requirements.” Union Financial’s total and Tier 1 capital exceed these requirements.

Bank holding companies are generally required to give the FRB prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of their consolidated net worth. The FRB may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe and unsound practice, or would violate any law, regulation, FRB order or directive, or any condition imposed by, or written agreement with, the FRB. There is an exception to this approval requirement for well-capitalized bank holding companies that meet certain other conditions.

The FRB has issued a policy statement regarding the payment of dividends by bank holding companies. In general, the FRB’s policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the Bank holding company appears consistent with the organization’s capital needs, asset quality, and overall financial condition. The FRB’s policies also require that a bank holding company serve as a source of financial strength to its subsidiary banks by standing ready to use available resources to provide adequate capital funds to those banks during periods of financial stress or adversity and by maintaining the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks where necessary. Furthermore, the FRB has authority to prohibit a bank holding company from paying a capital distribution where a subsidiary bank is undercapitalized. These regulatory policies could affect the ability of Union Financial to pay dividends or otherwise engage in capital distributions.

The FRB has general authority to enforce the BHCA as to Union Financial and may require a bank holding company to cease any activity or terminate control of any subsidiary engaged in an activity that the FRB believes constitutes a serious risk to the safety, soundness or stability of its bank subsidiaries.

Union Financial and its subsidiaries will be affected by the monetary and fiscal policies of various agencies of the United States Government, including the Federal Reserve System. In view of changing conditions in the national economy and money markets, it is impossible for the management of Union Financial accurately to predict future changes in monetary policy or the effect of such changes on the business or financial condition of Union Financial or the Bank.

State Regulation. Union Financial is also a “bank holding company” within the meaning of the South Carolina bank holding company laws, which assigns the same definition to “bank holding company” as the meaning set forth in section 2(a) of the BHCA. The prior approval of the South Carolina Board of Financial Institutions is required before Union Financial may merge or consolidate with another bank holding company. Such approval is

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also necessary for Union Financial to assume direct or indirect ownership or control of more than 5% of any class of voting stock of a bank holding company or bank, or control of substantially all of the assets of a bank holding company or bank.

Acquisition of Union Financial

Federal Regulation. Federal law requires that a notice be submitted to the FRB if any person (including a company), or group acting in concert, seeks to acquire 10% or more of Union Financial's outstanding voting stock, unless the FRB has found that the acquisition will not result in a change in control of Union Financial. The FRB has 60 days from the filing of a complete notice to act, taking into consideration certain factors, including the financial and managerial resources of the acquirer and the anti-trust effects of the acquisition.

Under the BHCA, any company would be required to obtain prior approval from the FRB before it may obtain "control" of Union Financial within the meaning of the BHCA. "Control" generally is defined to mean the ownership or power to vote 25% or more of any class of voting securities of Union Financial or the ability to control in any manner the election of a majority of Union Financial's directors. An existing bank holding company would be required to obtain the FRB's prior approval under the BHCA before acquiring more than 5% of Union Financial's voting stock. See "Holding Company Regulation." Approval of the South Carolina Board of Financial Institutions may also be required for acquisition of Union Financial under some circumstances.

Federal Banking Regulations

Capital Requirements. The OCC's capital regulations require national banks to meet two minimum capital standards: a 4% Tier 1 capital to total adjusted assets ratio for most banks (3% for national banks with the highest examination rating) (the "leverage" ratio) and an 8% risk-based capital ratio. In addition, the prompt corrective action standards discussed below also establish, in effect, a minimum 2% tangible capital to total assets standard, a 4% leverage ratio (3% for institutions receiving the highest rating on the financial institution examination rating system) and, together with the risk-based capital standard itself, a 4% Tier 1 capital to risk-based assets standard. "Tier 1 capital" is generally defined as common stockholders' equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships.

The risk-based capital standard requires the maintenance of Tier 1 and total capital (which is defined as Tier 1 capital plus Tier 2 capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100%, as assigned by the OCC capital regulation based on the risks that the agency believes are inherent in the type of asset. The regulators have recently added a market risk adjustment to cover a bank's trading account, foreign exchange and commodity positions. Tier 2 capital may include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets, and up to 45% of unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of Tier 2 capital included as part of total capital cannot exceed 100% of Tier 1 capital.

The FRB has adopted capital adequacy guidelines for bank holding companies (on a consolidated basis) substantially similar to those of the OCC for the Bank. Union Financial's total and Tier 1 capital exceed these requirements.

Both the OCC and the FRB have the discretion to establish higher capital requirements on a case-by-case basis where deemed appropriate in the circumstances of a particular bank or bank holding company.

Prompt Corrective Regulatory Action. Under the prompt corrective action regulations, the OCC is required to take certain supervisory actions against undercapitalized institutions under its jurisdiction, the severity of which depends upon the institution's degree of undercapitalization. Generally, an institution that has a ratio of total capital to risk weighted assets of less than 8%, a ratio of Tier 1 (core) capital to risk-weighted assets of less than 4% or a ratio of core capital to total assets of less than 4% (3% or less for institutions with the highest examination rating) is considered to be "undercapitalized." An institution that has a total risk-based capital ratio less than 6%, a Tier 1

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capital ratio of less than 3% or a leverage ratio that is less than 3% is considered to be “significantly undercapitalized” and an institution that has a tangible capital to assets ratio equal to or less than 2% is deemed to be “critically undercapitalized.” Subject to a narrow exception, the OCC is required to appoint a receiver or conservator within specified time frames for an institution that is “critically undercapitalized.” The regulation also provides that a capital restoration plan must be filed with the OCC within 45 days of the date an institution receives notice that it is “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized.” Compliance with the plan must be guaranteed by any parent holding company. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution, including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The OCC could also take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors.

Insurance of Deposit Accounts. Deposits of the Bank are insured by the Savings Association Insurance Fund (“SAIF”) maintained by the FDIC. The FDIC has adopted a risk-based insurance assessment system. The FDIC assigns an institution to one of three capital categories (well capitalized, adequately capitalized or undercapitalized) based on the institution’s financial information as of the reporting period ending seven months before the assessment period. The FDIC also assigns the institution to one of three supervisory subcategories within each capital group, based on a supervisory evaluation provided to the FDIC by the institution’s primary regulator and such other information that the FDIC deems relevant with respect to the financial condition and the risk posed to the deposit insurance funds. An institution’s assessment rate depends on the capital category and supervisory category to which it is assigned. Assessment rates for SAIF deposits are determined semi-annually and currently range from 0 basis points for well-capitalized institutions in the highest supervisory category to 27 basis points for the weakest institutions. The FDIC is authorized to raise the assessment rates in certain circumstances. The FDIC has exercised its authority to raise rates in the past and may raise insurance premiums in the future. If such action is taken by the FDIC, it could have an adverse effect on the earnings of the Bank.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation (“FICO”) to recapitalize the predecessor to the SAIF. FICO payments during 2004 approximated 1.51 basis points of assessable deposits.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the regulators. Bank management does not know of any practice, condition or violation that might lead to termination of deposit insurance.

Loans to One Borrower . National banks are subject to limits on the amount that they may lend to single borrowers. Generally, banks may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of its capital and surplus (including Tier 1 capital, Tier 2 capital and the amount of the allowance for loan and lease losses not included in Tier 2 capital). An additional amount may be lent, equal to 10% of capital and surplus, if such loan is secured by readily-marketable collateral, which is defined to include certain financial instruments and bullion. At December 31, 2004, the Bank’s limit on loans to one borrower was \$4.8 million and the Bank’s largest aggregate outstanding balance of loans to one borrower was \$3.2 million.

Limitation on Capital Distributions. National banks may not pay dividends out of their permanent capital and may not, without OCC approval, pay dividends in excess of the total of the bank’s retained net income for the year combined with retained net income for the prior two years less any transfers to surplus and capital distributions. A national bank may not pay a dividend that would cause it to fall below any applicable regulatory capital standard.

Branching. National banks are authorized to establish branches within the state in which they are headquartered to the extent state law allows branching by state banks. Federal law also provides for interstate branching for national banks. Interstate branching by merger was authorized as of June 1, 1997 unless the state in which the bank is to branch has enacted a law opting out of interstate branching or expedites the effective date by passing legislation. *De novo* interstate branching is permitted to the extent the state into which the bank is to branch has enacted a law authorizing out-of-state banks to establish *de novo* branches.

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Transactions with Related Parties. The authority of a depository institution to engage in transactions with related parties or “affiliates” (*e.g.* , any company that controls or is under common control with an institution, including Union Financial) is limited by Sections 23A and 23B of the Federal Reserve Act (“FRA”). Section 23A limits the aggregate amount of covered transactions with any individual affiliate to 10% of the capital and surplus of the depository institution. The aggregate amount of covered transactions with all affiliates is limited to 20% of the depository institution’s capital and surplus. Certain transactions with affiliates are required to be secured by collateral in an amount and of a type described in Section 23A and the purchase of low quality assets from affiliates is generally prohibited. Section 23B generally provides that certain transactions with affiliates, including loans and asset purchases, must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the institution as those prevailing at the time for comparable transactions with non-affiliated companies.

The authority of the Bank to extend credit to executive officers, directors and 10% shareholders (“insiders”), as well as entities such persons control, is governed by Sections 22(g) and 22(h) of the FRA and Regulation O thereunder. Among other things, such loans are required to be made on terms substantially the same as those offered to unaffiliated individuals and are not to involve more than the normal risk of repayment. There is an exception to this requirement for loans made pursuant to a benefit or compensation program that is widely available to all employees of the institution and does not give preference to insiders over other employees. Regulation O also places individual and aggregate limits on the amount of loans that institutions may make to insiders based, in part, on the institution’s capital position and requires certain board approval procedures to be followed.

Enforcement. The OCC has primary enforcement responsibility over national banks and has the authority to bring actions against such banks and all institution-affiliated parties, including directors, officers, stockholders, and any attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors to institution of receivership or conservatorship. Civil penalties cover a wide range of violations and can amount to \$25,000 per day, or even \$1.0 million per day in especially egregious cases. The FDIC has the authority to recommend to the OCC that it take enforcement action with respect to a national bank. If action is not taken by the agency, the FDIC has authority to take such action under certain circumstances. Federal law also establishes criminal penalties for certain violations. The FRB has generally similar enforcement authority with respect to Union Financial. Neither Union Financial nor the Bank are under any enforcement action.

Standards for Safety and Soundness. The federal banking agencies have adopted Interagency Guidelines Prescribing Standards for Safety and Soundness (“Guidelines”) and a final rule to implement safety and soundness standards required under federal law. The Guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The standards address internal controls and information systems; internal audit system; credit underwriting; loan documentation; interest rate risk exposure; asset growth; and compensation, fees and benefits. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the Guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. The final rule establishes deadlines for the submission and review of such safety and soundness compliance plans when such plans are required.

Community Reinvestment Act. The Community Reinvestment Act, as amended (“CRA”), as implemented by OCC regulations, provides that a national bank has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution’s discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the OCC, in connection with its examination of a bank, to assess the institution’s record of meeting the credit needs of its community and to take such record into account in its evaluation of certain corporate applications by such institution, such as mergers and branching. The Bank’s most recent rating was “satisfactory.”

USA Patriot Act. The USA Patriot Act of 2001 (the “Patriot Act”), designed to deny terrorists and others the ability to obtain anonymous access to the United States financial system, has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act mandates or will require financial institutions to implement additional policies and procedures with respect to, or

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additional measures designed to address matters such as: money laundering, suspicious activities and currency transaction reporting.

Federal Reserve System

The FRB regulations require savings institutions to maintain non-interest earning reserves against their transaction accounts (primarily NOW and regular checking accounts). The regulations generally provide that reserves be maintained against aggregate transaction accounts as follows: for accounts aggregating \$47.6 million or less (subject to adjustment by the FRB) the reserve requirement is 3%; and for accounts aggregating greater than \$47.6 million, a reserve requirement of 10% (subject to adjustment by the FRB between 8% and 14%) is applied against that portion of total transaction accounts in excess of \$47.6 million. The first \$7.0 million of otherwise reservable balances (subject to adjustments by the FRB) are exempted from the reserve requirements.

Federal Home Loan Bank System

The Bank is a member of the Federal Home Loan Bank System, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank provides a central credit facility primarily for member institutions. The Bank, as a member of the Federal Home Loan Bank of Atlanta, is required to acquire and hold shares of capital stock in the Federal Home Loan Bank of Atlanta in an amount at least equal to 1.0% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20 of its advances (borrowings) from the Federal Home Loan Bank of Atlanta, whichever is greater. The Bank was in compliance with this requirement with an investment in Federal Home Loan Bank stock at December 31, 2004 of \$3.5 million.

The Federal Home Loan Banks are required to provide funds for the resolution of insolvent thrifts and to contribute funds for affordable housing programs. These requirements could reduce the amount of dividends that the Federal Home Loan Banks pay to their members and could also result in the Federal Home Loan Banks imposing a higher rate of interest on advances to their members. If dividends were reduced, or interest on future Federal Home Loan Bank advances increased, the Bank's net interest income would likely also be reduced. Recent legislation has changed the structure of the Federal Home Loan Banks' funding obligations for insolvent thrifts, revised the capital structure of the Federal Home Loan Banks and implemented entirely voluntary membership for Federal Home Loan Banks. Management cannot predict the effect that these changes may have with respect to its Federal Home Loan Bank membership.

Item 2. Description of Property

The Corporation owns two banking offices and an operations center in Union, South Carolina, two banking offices in Winnsboro, South Carolina and a banking office in each of Laurens, Jonesville and Rock Hill, South Carolina. The net book value of the Corporation's investment in premises and equipment totaled approximately \$5.6 million at December 31, 2004. See Note 4 of Notes to Consolidated Financial Statements. All property is in good condition and meets the operating needs of the Corporation.

[Table of Contents](#)**Item 3. Legal Proceedings**

Neither Union Financial nor the Bank is engaged in any legal proceedings of a material nature at the present time. From time to time, the Bank is involved in routine legal proceedings occurring in the ordinary course of business wherein it enforces the Bank's security interest in mortgage loans the Bank has made.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2004.

PART II**Item 5. Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities**

For information related to the market for common equity and related stockholder matters, the information contained under the section captioned "Common Stock Market Price and Dividend Information" in the Annual Report to Shareholders (the "Annual Report") is incorporated herein by reference.

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|--|--|------------------------------------|---|--|
| October 1, 2004 through October 31, 2004 | 4,000 | \$ 17.32 | 4,000 | 25,882 |
| November 1, 2004 through November 30, 2004 | 10,200 | \$ 18.01 | 10,200 | 15,682 |
| December 1, 2004 through December 31, 2004 | 667 | \$ 17.95 | 667 | 15,015 |
| Total | 14,867 | \$ 17.82 | 14,867 | N/A |

- (1) On January 29, 2003, the Corporation announced that the Board of Directors had approved a stock repurchase program authorizing the Corporation to repurchase up to 98,000 shares of the Corporation's common stock. The repurchase program will continue until it is completed or terminated by the Board of Directors

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations

The information contained in the section captioned "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Annual Report is incorporated herein by reference.

Item 7. Financial Statements

The financial statements contained in the Annual Report are incorporated herein by reference.

[Table of Contents](#)**Item 8. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure**

No changes in or disagreements with the Corporation's independent accountants on accounting and financial disclosure has occurred during the two most recent fiscal years.

Item 8A. Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC") (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. In addition, based on that evaluation, no change in the Company's internal control over financial reporting occurred during the quarter ended December 31, 2004 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 8B. Other Information

None.

PART III**Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act**

For information concerning the Board of Directors of Union Financial, the information contained under the section captioned "Proposal I — Election of Directors" and "Directors' Compensation" in the Proxy Statement is incorporated herein by reference. Reference is made to the cover page of this Form 10-KSB and to the section captioned "Compliance with Section 16(a) of the Exchange Act" for information regarding compliance with section 16(a) of the Exchange Act.

For information concerning the Corporation's code of ethics, the information contained under the section captioned "Corporate Governance — Code of Business Conduct" in the Proxy Statement is incorporated herein by reference. A copy of the code of ethics is available, without charge, upon written request to Wanda J. Wells, Corporate Secretary, Union Financial Bancshares, Inc., 203 West Main Street, Union, South Carolina 29379.

Executive Officers of the Registrant

Certain executive officers of the Bank also serve as executive officers of Union Financial. The day-to-day management duties of the executive officers of Union Financial and the Bank relate primarily to their duties as to the Bank. The executive officers of Union Financial currently are as follows:

| <u>Name</u> | <u>Age (1)</u> | <u>Position as of December 31, 2004</u> |
|------------------|--------------------|--|
| Dwight V. Neese | 54 | President, Chief Executive Officer and Director |
| Richard H. Flake | 56 | Executive Vice President - Chief Financial Officer |
| Lud W. Vaughn | 54 | Executive Vice President - Chief Credit Officer |
| Edward A. Brock | 43 | Senior Vice President of the Bank |

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| <u>Name</u> | <u>Age (1)</u> | <u>Position as of December 31, 2004</u> |
|-------------------------|----------------|--|
| Wanda J. Wells | 49 | Senior Vice President - Chief Administrative Officer and Corporate Secretary |
| Mark F. Pack | 39 | Senior Vice President - Business Manager Program |
| Henry G. Alexander, Jr. | 44 | Vice President - Commercial Lending of the Bank |
| Carolyn H. Belue | 48 | Vice President - Operations Manager of the Bank |
| Brenda Billardello | 45 | Vice President - Marketing Director of the Bank |
| Lisa G. Morris | 32 | Vice President - Human Resources Manager of the Bank |
| Lori H. Patrick | 37 | Vice President - Market Executive of the Bank |
| Susan D. Taylor | 44 | Vice President - Fairfield Market Executive of the Bank |
| Jeff Thompson | 33 | Vice President |

(1) At December 31, 2004.

Dwight V. Neese was appointed as President and Chief Executive Officer of the Bank effective September 5, 1995. As President and Chief Executive Officer of the Bank and Union Financial, Mr. Neese is responsible for daily operations of the Bank and implementation of the policies and procedures approved by the Board of Directors.

Richard H. Flake joined Union Financial in September 1995.

Lud W. Vaughn joined Union Financial in April 2003. Prior to joining Union Financial, Mr. Vaughn was Senior Vice President for Bank of America in Rock Hill, South Carolina.

Edward A. Brock joined the Bank in November 2002. Before joining the Bank, Mr. Brock was a vice president—commercial banking for First Citizens Bank from December 2001 to November 2002 and a vice president -commercial lender of Bank of America form 1993 until December 2001.

Wanda J. Wells has been employed by the Bank since 1975.

Mark F. Pack joined Union Financial in December 2004. Prior to joining Union Financial, Mr. Pack was Vice President and Senior Commercial Account Manager for SouthTrust Bank in Charlotte, North Carolina.

Henry G. Alexander , Jr . has been employed by the Bank since 1983.

Carolyn H. Belue has been employed by the Bank since 1979.

Brenda Billardello joined the Bank in December 2004. Prior to joining the Bank, Ms. Billardello was a vice president of the York County Regional Chamber of Commerce.

Lisa G. Morris has been employed by the Bank since 1999.

Lori H. Patrick has been employed by the Bank since 1987.

Susan D. Taylor has been employed by the Bank since 1995.

Jeff Thompson has been employed by the Bank since 2000.

Item 10. Executive Compensation

The information contained under the sections captioned “Executive Compensation” and “Directors’ Compensation” in the Proxy Statement is incorporated herein by reference.

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Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

(a) Security Ownership of Certain Beneficial Owners

Information required by this item is incorporated herein by reference to the section captioned “Stock Ownership” in the Proxy Statement.

(b) Security Ownership of Management

Information required by this item is incorporated herein by reference to the section captioned “Stock Ownership” in the Proxy Statement.

(c) Management of Union Financial knows of no arrangements, including any pledge by any person of securities of Union Financial, the operation of which may at a subsequent date result in a change in control of the registrant.

(d) Equity Compensation Plan Information

The following table sets forth information about the Company common stock that may be issued upon the exercise of stock options, warrants and rights under all of the Company’s equity compensation plans as of December 31, 2004.

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c) |
|--|---|---|---|
| Equity compensation plans approved by security holders | 156,716 | \$ 10.20 | 33,623 |
| Equity compensation plans not approved by security holders | — | — | — |
| Total | 156,716 | \$ 10.20 | 33,623 |

Item 12. Certain Relationships and Related Transactions

The information required by this item is incorporated herein by reference to the section captioned “Transactions with Management” in the Proxy Statement.

PART IV

Item 13. Exhibits

Exhibits

- 3(a) Certificate of Incorporation(1)
- 3(b) Bylaws(2)
- 3(c) Certificate of Amendment of Certificate of Incorporation dated January 22, 1997(3)
- 3(d) Certificate of Amendment to Certificate of Incorporation dated January 28, 2004(4)

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| | |
|-------|---|
| 10(a) | Employment Agreement with Dwight V. Neese(5) |
| 10(b) | Employment Agreement with Richard H. Flake(5) |
| 10(c) | Union Financial Bancshares, Inc. 1995 Stock Option Plan(6) |
| 10(d) | Union Financial Bancshares, Inc. 2001 Stock Option Plan(7) |
| 10(e) | Change in Control Agreement with Lud W. Vaughn(5) |
| 10(f) | Change in Control Agreement with Edward A. Brock |
| 10(g) | Form of Stock Option Award Agreements |
| 13 | 2004 Annual Report to Shareholders |
| 21 | Subsidiaries of the Registrant |
| 23 | Consent of Independent Auditor |
| 31(a) | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer |
| 31(b) | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer |
| 32 | Section 1350 Certifications |

- (1) Incorporated herein by reference to Union Financial’s Registration Statement on Form S-4 (File No. 33-80808) filed with the Securities and Exchange Commission on June 29, 1994.
- (2) Incorporated herein by reference to Union Financial’s Form 10-KSB for the year ended September 30, 1999.
- (3) Incorporated herein by reference to Union Financial’s Form 10-KSB for the year ended September 30, 1997.
- (4) Incorporated herein by reference to Union Financial’s 10-QSB for the quarter ended December 31, 2003.
- (5) Incorporated herein by reference to Union Financial’s Form 10-KSB for the year ended September 30, 2003.
- (6) Incorporated herein by reference to Exhibit A to Union Financial’s Proxy Statement for its 1996 Annual Meeting of Stockholders.
- (7) Incorporated herein by reference to Appendix A to Union Financial’s Proxy Statement for its 2000 Annual Meeting of Stockholders.

Item 14. Principal Accountant Fees and Services

The information required by this Item is incorporated herein by reference to the section captioned “Proposal 2-Ratification of Appointment of Auditors” in the Proxy Statement.

[Table of Contents](#)**SIGNATURES**

In accordance with the requirements of Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

UNION FINANCIAL BANCSHARES, INC.

Date: March 15, 2005

By: /s/ Dwight V. Neese
Dwight V. Neese
President and Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ Dwight V. Neese
Dwight V. Neese
(Principal Executive Officer)

Date: March 15, 2005

By: /s/ Richard H. Flake
Richard H. Flake
(Principal Financial and Accounting Officer)

Date: March 15, 2005

By: /s/ Robert A. Breakfield
Robert A. Breakfield
Director

Date: March 15, 2005

By: /s/ James W. Edwards
James W. Edwards
Director

Date: March 15, 2005

By: /s/ William M. Graham
William M. Graham
Director

Date: March 15, 2005

By: /s/ Louis M. Jordan
Louis M. Jordan
Director

Date: March 15, 2005

By: /s/ Carl L. Mason
Carl L. Mason
Director

Date: March 15, 2005

By: /s/ Philip C. Wilkins
Philip C. Wilkins
Director

Date: March 15, 2005

Exhibit 10(f)

AGREEMENT

THIS AGREEMENT is made effective as of November 4, 2002 by and between PROVIDENT COMMUNITY BANK (the "Bank"); UNION FINANCIAL BANCSHARES, INC. (the "Company"); and Edward A. Brock ("Executive").

WHEREAS, Executive serves in the position of Vice President and Senior Commercial Relationship Manager of the Bank, a position of substantial responsibility; and

WHEREAS, the Bank recognizes the substantial contribution Executive has made to the Bank and wishes to protect her position therewith for the period provided for in this Agreement.

NOW, THEREFORE, in consideration of the foregoing and upon the other terms and conditions hereinafter provided, the parties hereto agree as follows:

1. Term of Agreement

a.) The term of this Agreement shall be (i) the period commencing on November 4, 2002 (the "Effective Date") and continuing for a period of twelve months thereafter; plus (ii) any and all extensions of the term made pursuant to this Section 1.

b.) Commencing on the Effective Date and on each day thereafter, the term under this agreement shall be renewed automatically for an additional one (1) day period beyond the then effective expiration date without action by any party, provided that neither the Company, on the one hand, nor Executive, on the other, shall have given at least sixty (60) days written notice of its or her desire that the term not be renewed. In the case such notice is given by one party to the other, the term of this Agreement shall become fixed and shall end on the second anniversary of the date of written notice.

2. Payments to Executive Upon a Change in Control.

a.) Upon the occurrence of a Change in Control (as herein defined) followed within twelve (12) months of the effective date of a Change in Control by the voluntary or involuntary termination of Executive's employment, other than Termination for Cause, as defined in Section 2(c) hereof, the provisions of Section 3 shall apply. For purposes of this Agreement, "voluntary termination" shall be limited to the circumstances in which, during the term of this Agreement, Executive elects to voluntarily terminate her employment within twelve (12) months of the effective date of a Change in Control following any demotion, loss of title, office of significant authority, reduction in her annual compensation or benefits (other than a reduction affecting the Bank's personnel generally), or relocation of her principal place of employment by more than thirty-five (35)miles from its location immediately prior to the Change in Control.

b.) A "Change in Control" of the Company of the Bank shall be deemed to occur if and when (a) an offeror other than the Company purchases shares of the common stock of the Company or the Bank pursuant to a tender or exchange offer for such shares, (b) any person (as such term is used in Sections 13(d) and 14(d)(2) of the Securities Exchange Act of 1934) is or becomes the beneficial owner, directly or indirectly, of securities of the Company or the Bank representing 25% or more of the combined voting power of the Company's then outstanding securities, (c) the membership of the board of directors of

the Company or the Bank changes as the result of a contested election, such that individuals who were directors at the beginning of any twenty-four (24) month period (whether commencing before or after the date of adoption of this Agreement) do not constitute a majority of the Board at the end of such period, or (d) shareholders of the Company or the Bank approve a merger, consolidation, sale of disposition of all or substantially all of the Company's or the Bank's assets, or a plan of partial or complete liquidation.

c.) Executive shall not have the right to receive termination benefits pursuant to Section 3 hereof upon Termination for Cause. The term "Termination for Cause" shall mean termination because of Executive's intentional failure to perform stated duties, personal dishonesty, incompetence, willful misconduct, any breach of fiduciary duty involving personal profit, willful violation of any law, rule regulation (other than traffic violations or similar offenses) or final cease and desist order, or any material breach of any material provision of this Agreement. In determining incompetence, the acts or omissions shall be measured against standards generally prevailing in the savings institution industry. Notwithstanding the foregoing, Executive shall not be deemed to have been Terminated for Cause unless and until there shall have been delivered to him a copy of a resolution duly adopted by the affirmative vote of not less than three-fourths (3/4) of the members of the Board at a meeting of the Board called and held for that purpose (after reasonable notice to Executive and an opportunity for him, together with counsel, to be heard before the Board), finding that in the good faith opinion of the Board, Executive was guilty of conduct justifying Termination for Cause and specifying the particulars thereof in detail. Executive shall not have the right to receive compensation or other benefits for any period after Termination for Cause.

3. Termination

a.) Upon the occurrence of a Change in Control, followed within twelve (12) months of the effective date of a Change in Control by the voluntary or involuntary termination of Executive's employment other than for Termination for Cause, the Bank shall be obligated to pay Executive, or in the event of her subsequent death, her beneficiary or beneficiaries, or her estate, as the case may be, as severance pay, a sum equal to one (1) times Executive's base salary as in effect on the effective date of a Change in Control. Such amount shall be paid to Executive in a lump sum no later than thirty (30) days after the date of her termination.

b.) Upon the occurrence of a Change in Control of the Bank followed within twelve (12) months of the effective date of a Change in Control by Executive's voluntary or involuntary termination of employment, other than for Termination for Cause, the Bank shall cause to be continued life, medical, dental and disability coverage substantially identical to the coverage maintained by the Bank for Executive prior to her severance. Such coverage and payments shall cease upon expiration of twelve (12) months from the date of Executive's termination.

c.) Notwithstanding the preceding paragraphs of this Section 3, in the event that the aggregate payments or benefits to be made or afforded to Executive under this Section would be deemed to include an "excess parachute payment" under Section 280G of the Code, such payments or benefits shall be payable or provided to Executive in equal monthly installments over the minimum period necessary to reduce the present value of

such payments or benefits to an amount which is one dollar (\$1.00) less than three (3) times Executive's "base amount" as defined under Section 280G of the Code.

d.) Any payments made to Executive pursuant to this Agreement, or otherwise, are subject to and conditioned upon compliance with 12 U.S.C. §1828 (k) and any regulations promulgated thereunder.

4. Effect on Prior Agreements and Existing Benefit Plans

This Agreement contains the entire understanding between the parties hereto and supersedes any prior agreement between the Bank and Executive, except that this Agreement shall not affect or operate to reduce any benefit or compensation inuring to Executive of a kind elsewhere provided. No provision of this Agreement shall be interpreted to mean that Executive is subject to receiving fewer benefits than those available to him without reference to this Agreement.

5. No Attachment

a.) Except required by law, no right to receive payments under this Agreement shall be subject to anticipation, commutation, alienation, sale, assignment, encumbrance, charge, pledge, or hypothecation, or to execution, attachment, levy, or similar process or assignment by operation of law, and any attempt, voluntary or involuntary, to affect any such action shall be null, void and of no effect.

b.) This Agreement shall be binding upon, and inure to the benefit of, Executive, the Company, the Bank and their respective successors and assigns.

6. Modification and Waiver

a.) This Agreement may not be modified or amended except by an instrument in writing signed by the parties hereto.

b.) No term or condition of this Agreement shall be deemed to have been waived, nor shall there be an estoppel against the enforcement of any provision of this Agreement, except by written instrument of the party charged with such waiver or estoppel. No such written waiver shall be deemed a continuing waiver unless specifically stated therein, and each such waiver shall operate only as to the specific term or condition waived and shall not constitute a waiver of such term or condition for the future or as to any act other than that specifically waived.

7. Required Provisions

a.) The Bank may terminate Executive's employment at any time, but any termination by the Bank, other than Termination for Cause, shall not prejudice Executive's right to compensation or other benefits under this Agreement. Executive shall not have the right to receive compensation or other benefits for any period after Termination for Cause as defined in Section 2(c) herein.

b.) If Executive is suspended and/or temporarily prohibited from participating in the conduct of the Bank's affairs by a notice served under Section 8 (e)(3) or (g)(1) of the

Federal Deposit Insurance Act (“FDIA”) (12 U.S.C. 1818(e)(3) and (g)(1)), the Bank’s obligations under the Agreement shall be suspended as of the date of service, unless stayed by appropriate proceedings. If the charges in the notice are dismissed, the Bank may, in its discretion, (i) pay Executive all or part of the compensation withheld while its contract obligations were suspended and (ii) reinstate (in whole or in part) any of its obligations that were suspended.

c.) If Executive is removed and/or permanently prohibited from participating in the conduct of the Bank’s affairs by an order issued under Section 8(e)(4) or (g)(1) of the FDIA (12 U.S.C. 1818(e)(4) or (g)(1)), all obligations of the Bank under the Agreement shall terminate as of the effective date of the order, but vested rights of the contracting parties shall not be affected.

d.) If the Bank is in default (as defined in Section 3(x)(1) of the FDIA), all obligations under this Agreement shall terminate as of the date of default, but this paragraph shall not affect any vested rights of the parties.

e.) All obligations under this Agreement may be terminated: (i) by the Director of the Office of Thrift Supervision (the “Director”) or his or her designee at the time the Federal Deposit Insurance Corporation or the Resolution Trust Corporation enters into an agreement to provide assistance to or on behalf of the Bank under the authority contained in Section 13(c) of the FDIA and (ii) by the Directors, or his or her designee at the time the Director or such designee approves a supervisory merger to resolve problems related to operation of the Bank or when the Bank is determined by the Director to be in an unsafe or unsound condition. Any rights of the parties that have already vested, however, shall not be affected by such action.

8. Severability

If, for any reason, any provision of this Agreement, or any part of any provision, is held invalid, such invalidity shall not affect any other provision of this Agreement or any part of such provision not held so invalid, and each such other provision and part thereof shall to the full extent consistent with law continue in full force and effect.

9. Headings for Reference Only

The headings of sections and paragraphs herein are included solely for convenience of reference and shall not control the meaning or interpretation of any of the provisions of this Agreement.

10. Governing Law

The validity, interpretation, performance, and enforcement of this Agreement shall be governed by the laws of the State of South Carolina, unless preempted by Federal law as now or hereafter in effect.

Any dispute or controversy arising under or in connection with this Agreement shall be settled exclusively by arbitration, conducted before a panel of three arbitrators sitting in a location selected by the employee within fifty (50) miles from the location of the Bank, in accordance with the rules of the American Arbitration Association then in effect.

- (i) State the election to exercise the Option, the number of shares with respect to which it is being exercised, the person in whose name the stock certificate or certificates for such shares of Common Stock is to be registered, his or her address and Social Security Number (or if more than one, the names, addresses and Social Security Numbers of such person);
- (ii) Be signed by the person or persons entitled to exercise the Option and, if the Option is being exercised by any person or persons other than the Optionee, be accompanied by proof, satisfactory to counsel for the Company, of the right of such person or persons to exercise the Option; and
- (iii) Be in writing and delivered in person or by certified mail to the Treasurer of the Company or any other person designated by the Stock Option Committee of the Company.

Payment of the purchase price of any shares with respect to which the Option is being exercised shall be by certified or bank cashier's or teller's check or as otherwise provided by the Plan. The certificate or certificates for shares of Common Stock as to which the Option shall be exercised shall be registered in the name of the person or persons exercising the Option.

(c) Restrictions on exercise. This option may not be exercised if the issuance of the shares upon such exercise would constitute a violation of any applicable federal or state securities or other law or valid regulation. As a condition to the Optionee's exercise of this option, the Company may require the person

exercising this option to make any representation and warranty to the Company as may be required by any applicable law or regulation.

3. Nontransferability of Option . Except as otherwise provided in the Plan, this Option may not be transferred in any manner than by will or the laws of descent or distribution and may be exercised during the lifetime of the Optionee only by the Optionee. The terms of this Option shall be binding upon the executors, administrators, heirs, successors and assigns of the Optionee.

4. Term of Option . Subject to Section 2(a) of this agreement, this Option may be exercised through and including _____, and may be exercised during such term only in accordance with the Plan and the terms of this Option.

Optionee

By: _____
Dwight V. Neese, President & CEO

Attest: _____
Wanda J. Wells, Corporate Secretary

Date of
Grant: _____

**STOCK OPTION AGREEMENT
FOR DIRECTOR OPTIONS
PURSUANT TO THE
UNION FINANCIAL BANCSHARES
2001 STOCK OPTION PLAN**

DIRECTOR OPTION for a total _____ Shares of common sock, par value \$0.01 per Share, of Union Financial Bancshares, Inc. (the "Company"), is hereby granted to _____ (the "Optionee") at an exercise price determined as provided in, and in all respects to, the terms, definitions and provisions of the 2001 Stock Option Plan (the "Plan") adopted by the Company, which is incorporated by reference herein, receipt of which is hereby acknowledged.

1. Exercise Price. This Director Option shall be exercisable at \$ _____ for each Share, being 100 percent of the fair market value of the common stock of the Company on the date of this option.

2. Exercise of Director Option.

(a) Vesting. This Director Option shall be exercisable as follows:

Options shall vest 100% upon retirement.

(b) Method of Exercise. This Director Option shall be exercisable by a written notice which shall:

(i) State the election to exercise the Director Option, the number of Shares with respect to which it is being exercised, the person in whose name the stock certificate or certificates for such Shares is to be registered, his or her address and Social Security Number (or if more than one, the names, addresses and Social Security Numbers of such persons);

(ii) Be signed by the person or persons entitled to exercise the Director Option, and if the Director Option is being exercised by any person or persons other than the Optionee, be accompanied by proof, satisfactory to counsel for the Company, of the right of such person or persons to exercise the Director Option; and

(iii) Be in writing and delivered in person or by certified mail to the Treasurer of the Company or any other person designated by the Stock Director Option Committee of the Company.

Payment of the purchase price of any Shares with respect to which the director Option is being exercised shall be by certified or bank cashier's or teller's check or as otherwise provided by the Plan. The certificate or certificates for Shares as to which the Director Option shall be exercised shall be registered in the name of the person or persons exercising the Director Option.

(c) Restrictions on exercise. This Director Option may not be exercised if the issuance of the Shares upon such exercise would constitute a violation of any applicable federal or state securities or other law or valid regulation. As a condition to the Optionee's exercise of this option, the Company may require the person exercising this option to make any representation and warranty to the Company as may be required by any applicable law or regulation.

3. Nontransferability of Director Option . Except as otherwise provided in the Plan, this Director Option may not be transferred in any manner otherwise than by will or the laws of descent or distribution and may be exercised during the lifetime of the Optionee only by the Optionee. The terms of the Director Option shall be binding upon the executors, administrators, heirs, successors and assigns of the Optionee.

4. Term of Director Option . Subject to Section 2(a) of this Agreement, this Director's Option is exercisable through and including _____, provided, however, that this Director Option may be exercised during such term only in accordance with the Plan and this Agreement.

Optionee

By: _____

Carl L. Mason, Chairman of the Board

Attest: _____

Dwight V. Neese, President

Date of
Grant: _____

Exhibit 13.0

**Union Financial Bancshares, Inc.
2004 Supplemental Annual Report**

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Business

Union Financial Bancshares, Inc. ("Union Financial") is the bank holding company for Provident Community Bank, N.A., (the "Bank"). Union Financial engages in no significant activity other than holding the stock of the Bank and engaging in certain passive investment activities. Union Financial, and the Bank are collectively referred to as the "Corporation" in this annual report.

The Bank is a national bank headquartered in Union, South Carolina. The Bank, originally chartered in 1934, is a member of the Federal Home Loan Bank System ("FHLB"). Its deposits are insured to the maximum limits allowable by the Federal Deposit Insurance Corporation ("FDIC").

The business of the Bank consists primarily of attracting deposits from the general public and originating loans on properties located in South Carolina. The Bank originates consumer and commercial loans, commercial real estate loans, construction loans, and residential mortgage loans, invests in federal government and agency obligations and purchases fixed and variable rate mortgage participation certificates. The principal sources of funds for the Bank's lending and investing activities include deposits received from the general public, advances from the FHLB and other borrowings. The Bank's principal expenses are interest paid on deposit accounts and other borrowings and expenses incurred in the operation of the Bank. The Bank's operations are conducted through its main office and six full-service banking centers, all of which are located in the upstate area of South Carolina.

SELECTED FINANCIAL AND OTHER DATA

Operations Data:

| | Year Ended December 31, | Three Months Ended December 31, | Years Ended September 30, | | | |
|--|--|--|---------------------------|-----------|-----------|-----------|
| | 2004 | 2003 | 2003 | 2002 | 2001 | 2000 |
| | <i>(In Thousands - Except Share and Per Share Amounts)</i> | | | | | |
| Interest income | \$ 16,952 | \$ 3,787 | \$ 16,924 | \$ 18,361 | \$ 19,018 | \$ 18,555 |
| Interest expense | (7,246) | (2,305) | (8,702) | (9,775) | (11,613) | (11,175) |
| Net interest income | 9,706 | 1,482 | 8,222 | 8,586 | 7,405 | 7,380 |
| Provision for loan losses | (1,250) | (725) | (725) | (990) | (240) | (225) |
| Net interest income after provision for loan losses | 8,456 | 757 | 7,497 | 7,596 | 7,165 | 7,155 |
| Other income | 2,583 | (283) | 2,211 | 1,308 | 1,149 | 2,580 |
| Other expense | (8,162) | (2,326) | (7,278) | (6,602) | (6,250) | (6,352) |
| Income (loss) before income taxes | 2,877 | (1,852) | 2,430 | 2,302 | 2,064 | 3,383 |
| Income tax (expense) benefit | (721) | 642 | (571) | (558) | (721) | 1,190 |
| Net income (loss) | \$ 2,156 | (\$ 1,210) | \$ 1,859 | \$ 1,744 | \$ 1,343 | \$ 2,193 |
| Net income (loss) per common share (Basic) | \$ 1.10 | (\$ 0.62) | \$ 0.95 | \$ 0.90 | \$ 0.70 | \$ 1.18 |
| Net income (loss) per common share (Diluted) | \$ 1.05 | (\$ 0.62) | \$ 0.90 | \$ 0.86 | \$ 0.68 | \$ 1.16 |
| Dividends paid per common share | \$ 0.40 | \$ 0.10 | \$ 0.40 | \$ 0.40 | \$ 0.40 | \$ 0.40 |
| Weighted average number of common shares outstanding (Basic) | 1,957,760 | 1,967,217 | 1,963,775 | 1,939,084 | 1,918,431 | 1,855,706 |
| Weighted average number of common shares outstanding (Diluted) | 2,044,137 | 1,967,217 | 2,056,579 | 2,030,040 | 1,971,611 | 1,898,494 |

Financial Condition :

| | At December 31 , | | At September 30, | | | |
|--|------------------|------------|------------------|------------|------------|------------|
| | 2004 | 2003 | 2003 | 2002 | 2001 | 2000 |
| <i>(Dollars Thousands)</i> | | | | | | |
| Total amount of: | | | | | | |
| Assets | \$ 351,598 | \$ 331,884 | \$ 341,704 | \$ 310,968 | \$ 277,752 | \$ 260,564 |
| Cash and cash equivalents | 13,197 | 28,702 | 3,290 | 7,385 | 5,694 | 4,500 |
| Investment securities | 104,598 | 77,183 | 78,790 | 28,913 | 24,170 | 19,432 |
| Mortgage-backed securities | 38,896 | 46,606 | 78,648 | 88,720 | 64,947 | 47,460 |
| Loans (net) | 171,094 | 154,501 | 152,921 | 161,576 | 158,063 | 167,807 |
| Deposits | 227,589 | 223,131 | 220,232 | 200,303 | 194,079 | 187,974 |
| Advances from Federal Home Loan Bank and other borrowings | 63,500 | 68,500 | 74,000 | 57,000 | 46,007 | 47,687 |
| Securities sold under agreement to repurchase | 24,000 | 5,000 | 11,000 | 17,000 | 11,000 | — |
| Floating rate junior subordinated deferrable interest debentures | 8,247 | — | — | — | — | — |
| Corporate obligated floating rate capital securities | — | 8,000 | 8,000 | 8,000 | — | — |
| Shareholders' equity | 26,019 | 25,507 | 26,216 | 27,198 | 24,376 | 21,924 |
| Number of: | | | | | | |
| Real estate loans outstanding | 898 | 1,070 | 1,147 | 1,503 | 1,783 | 2,216 |
| Deposit accounts | 19,567 | 19,449 | 19,557 | 19,506 | 20,499 | 22,418 |
| Banking centers | 7 | 7 | 7 | 6 | 6 | 7 |

Other Selected Data :

| | Year Ended | Years Ended September 30, | | | |
|---|----------------------|---------------------------|--------|--------|--------|
| | December 31, 2004 | 2003 | 2002 | 2001 | 2000 |
| Interest rate spread during the year | 2.94% | 2.56% | 2.97% | 2.98% | 3.02% |
| Net yield on average interest- earning assets | 2.96% | 2.63% | 3.08% | 3.08% | 3.10% |
| Return on average assets | 0.61% | 0.55% | 0.59% | 0.51% | 0.85% |
| Return on average shareholders' equity | 8.40% | 6.64% | 7.06% | 6.03% | 10.92% |
| Dividend payout ratio | 36.32% | 42.29% | 44.55% | 57.03% | 26.13% |
| Operating expense to average assets | 2.14% | 2.17% | 2.22% | 2.39% | 2.44% |
| Ratio of average shareholders' equity to average assets | 7.28% | 8.34% | 8.31% | 8.50% | 7.78% |

Management's Discussion and Analysis of Financial Condition and Results of Operations

Critical Accounting Policies

The Corporation has adopted various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of financial statements. The significant accounting policies of the Corporation are described in the footnotes to the consolidated financial statements.

Certain accounting policies involve significant judgments and assumptions by management which could have a material impact on the carrying value of certain assets and liabilities. Management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and estimates which could have a material impact on the carrying values of assets and liabilities and the results of operations of the Corporation.

The Corporation believes the allowance for loan losses is a critical accounting policy that requires significant judgments and estimates used in the preparation of consolidated financial statements. Management reviews the level of the allowance on a monthly basis and establishes the provision for loan losses based on the nature and volume of the loan portfolio, overall portfolio quality, delinquency levels, a review of specific problem loans, loss experience, economic conditions, and other factors related to the collectibility of the loan portfolio. A portion of the allowance is established by segregating the loans by residential mortgage, commercial and consumer loans and assigning allocation percentages based on historical loss experience and delinquency trends. The applied allocation percentages are reevaluated annually to ensure their relevance in the current economic environment. Accordingly, increases in the size of the loan portfolio and the increased emphasis on commercial real estate and commercial business loans, which carry a higher degree of risk of default and, thus, a higher allocation percentage, increases the allowance. Additionally, a portion of the allowance is established based on the level of specific classified assets.

Although the Corporation believes that it uses the best information available to establish the allowance for loan losses, future additions to the allowance may be necessary based on estimates that are susceptible to change as a result of changes in economic conditions and other factors. In addition, the Office of the Comptroller of the Currency, as an integral part of its examination process, will periodically review the Corporation's allowance for loan losses. Such agency may require the Corporation to recognize adjustments to the allowance based on its judgments about information available to it at the time of its examination. See notes 1 and 3 to the notes to financial statements included in this annual report for a detailed description of the Corporation's estimation process and methodology related to allowance for loans losses.

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations and other portions of this report contain certain "forward-looking statements" concerning the future operations of the Corporation. Management desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing the Corporation of the protections of such safe harbor with respect to all "forward-looking statements" contained in the Annual Report. The Corporation has used "forward-looking statements" to describe future plans and strategies. Forward looking statements are generally preceded by such terms as "expects," "believes," "anticipates," "intends" and similar expressions. Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could affect actual results include interest rate trends, the general economic climate in the Corporation's market area and the country as a whole, the ability of the Corporation to control costs and expenses, the products and pricing of its competitors, loan delinquency rates, and changes in federal and state regulation. These factors should be considered in evaluating the "forward-looking statements" and undue reliance should not be placed on such statements. Except as required by applicable law and regulation, the Corporation does not undertake and specifically disclaims any obligation to publicly release the results of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

Asset and Liability Management

The Corporation is committed to following a program of asset and liability management in an effort to manage the fluctuations in earnings caused by movements in interest rates. A significant portion of the Corporation's income results from the spread between the yield realized on its interest-earning assets and the rate of interest paid on its deposits and other borrowings. Differences in the timing and volume of repricing assets versus the timing and volume of repricing liabilities expose the Corporation to interest rate risk. Management's policies are directed at minimizing the impact on earnings of movements in interest rates.

The Corporation's Asset/Liability Committee makes pricing and marketing decisions on deposit and loan products in conjunction with managing the Corporation's interest rate risk. In addition, the Asset/Liability Committee reviews the Bank's securities portfolio, FHLB advances and other borrowings as well as the Bank's asset and liability policies.

At December 31, 2004, the Corporation had more interest-rate sensitive assets than liabilities that would reprice over the next twelve months. For the year ended December 31, 2004, the average balance of the loan portfolio increased \$3.8 million while the average balance of investment and mortgage-backed securities increased \$14.9 million. The higher amount of investment and mortgage-backed securities as a percentage of total assets, which carry a lower yield than loans, resulted in the average yield on interest-earning assets declining. However, due to the Corporation's focus on lower cost demand deposit accounts, overall funding costs decreased at a faster rate than the decline in yield on earning assets, resulting in a higher interest rate spread. The Corporation expects that its loan portfolio will continue to increase in the future, resulting in a larger yield in a rising interest rate environment. The Corporation continues to work to shorten the average life of its assets through the origination of shorter-term variable-rate consumer and commercial loans and the decline in originations of longer-term fixed-rate real estate loans and to extend the term on its liabilities in an effort to provide a better match of repricing for interest earning assets and interest bearing liabilities. The Corporation has established policies and monitors results to control interest rate sensitivity. Although the Corporation utilizes measures such as static gap, which is simply the measurement of the difference between interest-sensitive assets and interest-sensitive liabilities repricing for a particular time period, just as important a process is the evaluation of how particular assets and liabilities are impacted by changes in interest rates or selected indices as they reprice. Asset/liability modeling techniques are utilized by the Corporation to assess varying interest rate and balance sheet mix assumptions.

The primary objective of Asset/Liability management at the Corporation is to manage interest rate risk and achieve reasonable stability in net interest income throughout interest rate cycles in order to maintain adequate liquidity. This is achieved by maintaining the proper balance of rate-sensitive earning assets and rate-sensitive costing liabilities. The relationship of rate-sensitive earning assets to rate-sensitive costing liabilities is the principal factor in projecting the effect that fluctuating interest rates will have on future net interest income. Rate-sensitive assets and interest-bearing liabilities are those that can be repriced to current market rates within a relatively short time period. Management monitors the rate sensitivity of earning assets and interest-bearing liabilities over the entire life of these instruments, but places particular emphasis on the first year. At December 31, 2004, approximately 64% of the Corporation's interest-earning assets were scheduled to reprice or to mature within one year compared to approximately 50% of interest-bearing liabilities.

The following table shows the Corporation's rate-sensitive position at December 31, 2004 as measured by gap analysis (the difference between the interest-earning asset and interest-bearing liability amounts scheduled to be repriced to current market rates in subsequent periods). Over the next twelve months approximately \$49 million more interest-earning assets than interest-bearing liabilities can be repriced to current market rates at least once. As a result, at December 31, 2004, the ratio of rate-sensitive assets to rate-sensitive liabilities within the one-year time frame was 130%, indicating an "asset-sensitive" position. Corporations in an asset sensitive position would expect rising interest rates to have a positive impact on net interest income and falling interest rates to have a negative impact.

The following table sets forth the Corporation's interest sensitivity position as of December 31, 2004.

Interest Sensitivity Analysis
(dollars in thousands)

| | Within 12 Months | 1-5 Years | Over 5 Years | Total |
|--|---------------------|-------------------|------------------|-------------------|
| INTEREST-EARNING ASSETS | | | | |
| Investment Securities | \$ 85,694 | \$ 28,731 | \$ 44,741 | \$ 159,166 |
| Loans | 126,491 | 33,386 | 12,015 | 171,892 |
| Total interest-earning assets | 212,185 | 62,117 | 56,756 | 331,058 |
| INTEREST-BEARING LIABILITIES | | | | |
| Deposits | 130,148 | 85,364 | 12,077 | 227,589 |
| Other Borrowings | 25,000 | 40,500 | 22,000 | 87,500 |
| Floating rate junior subordinated deferrable interest debentures | 8,247 | — | — | 8,247 |
| Total interest-bearing liabilities | \$ 163,395 | \$ 125,864 | \$ 34,077 | \$ 323,036 |
| Interest sensitive gap | \$ 48,590 | (\$ 63,747) | \$ 22,679 | |
| Cumulative interest sensitive gap | \$ 48,590 | (\$ 15,157) | \$ 7,522 | |
| RSA/RSL | 130% | | | |

Management is not aware of any known events or uncertainties that will have or are reasonably likely to have a material effect on the Corporation's liquidity, capital resources or results of operations. Management is not aware of any current recommendations by the regulatory authorities, which if they were to be implemented, would have a material effect on the Corporation's liquidity, capital resources or results of operations.

Yields Earned and Rates Paid

The Corporation's pretax earnings depend primarily on its net interest income, the difference between the income it receives on its loan portfolio and other investments and its cost of funds, consisting primarily of interest paid on savings deposits and borrowings. Net interest income is affected by the average yield on interest-earning assets, the average rate on interest-bearing liabilities, and the ratio of interest-earning assets to interest-bearing liabilities.

The following table sets forth, at or for the periods and dates indicated, the weighted average yields earned on the Corporation's interest-earning assets, the weighted average interest rates paid on the Corporation's deposit accounts and borrowings, the interest rate spread and net yield on interest-earning assets.

| | At December 31, 2004 | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|---|-------------------------|------------------------------------|---|------------------------------|--------------|
| | | | | 2003 | 2002 |
| Average yield on earnings assets: | | | | | |
| Loans | 6.54% | 6.49% | 6.36% | 6.94% | 7.58% |
| Investments (1) | 3.88% | 3.87% | 3.10% | 3.95% | 5.47% |
| Mortgage-backed securities | 4.23% | 3.93% | 3.56% | 3.78% | 4.52% |
| Total interest-earning assets | 5.30% | 5.18% | 4.83% | 5.41% | 6.58% |
| Less: | | | | | |
| Average rate paid on deposits | 1.87% | 1.77% | 1.86% | 2.25% | 3.06% |
| Average rate paid on borrowings | 3.07% | 3.23% | 5.84% | 4.13% | 5.04% |
| Average Cost of Funds | 2.23% | 2.24% | 2.98% | 2.85% | 3.61% |
| Average interest rate spread | 3.07% | 2.94% | 1.85% | 2.56% | 2.97% |
| Net yield on average interest-earning assets | 3.16% | 2.96% | 1.89% | 2.63% | 3.08% |

(1) Includes investment securities, federal funds sold, interest-bearing time deposits, overnight interest-bearing deposits, Federal Home Loan Bank stock and Federal Reserve stock.

Rate/Volume Analysis

The following table sets forth certain information regarding changes in interest income and interest expense of the Corporation for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) changes in volume (changes in volume multiplied by prior rate) and (2) changes in rate (changes in rate multiplied by prior volume). The net change attributable to the combined impact of rate and volume has been allocated to rate and volume variances consistently on a proportionate basis.

| | Years Ended December 31 2004 vs. September 30, 2003 | | | Years Ended September 30, 2003 vs. 2002 | | |
|--------------------------------------|---|-----------------|-----------------|--|-----------------|-----------------|
| | Volume | Rate | Total | Volume | Rate | Total |
| <i>(Dollars in Thousands)</i> | | | | | | |
| Change in interest income: | | | | | | |
| Loans | \$ 199 | (\$ 714) | (\$ 515) | (\$ 593) | (\$ 1,011) | (\$ 1,604) |
| Mortgage-backed securities | (1,168) | 45 | (1,123) | 312 | (1,334) | (1,022) |
| Investments | 1,692 | (25) | 1,667 | 1,617 | (428) | 1,189 |
| Total interest income | 723 | (694) | 29 | 1,336 | (2,773) | (1,437) |
| Change in interest expense: | | | | | | |
| Deposits | 306 | (1,063) | (757) | 343 | (1,684) | (1,341) |
| Borrowings and other | 237 | (935) | (698) | 1,157 | (889) | 268 |
| Total interest expense | 543 | (1,998) | (1,455) | 1,500 | (2,573) | (1,073) |
| Change in net interest income | \$ 180 | \$ 1,304 | \$ 1,484 | (\$ 164) | (\$ 200) | (\$ 364) |

Results of Operations

Comparison of Years Ended December 31, 2004 and September 30, 2003

Net income increased \$297,000 or 15.98% from \$1,859,000 for the twelve months ended September 30, 2003 to \$2,156,000 for the twelve months ended December 31, 2004. Earnings per share were \$1.10 per share (basic) and \$1.05 per share (diluted) for the year ended December 31, 2004 compared to \$.95 per share (basic) and \$.90 per share (diluted) for the year ended September 30, 2003.

Interest Income

Total interest income increased \$28,000, or 0.17%, from \$16,924,000 in fiscal 2003 to \$16,952,000 in fiscal 2004. Interest income on loans decreased \$515,000, or 4.72%, from \$10,914,000 in year 2003 to \$10,399,000 in year 2004 due primarily to declining market interest rates along with higher loan originations in variable and prime-based loan products. The Corporation's continued focus on variable and prime-based lending resulted in net growth in consumer/commercial loans of 20.55% while net residential mortgage loans declined 3.76%. Interest income on investment and mortgage-backed securities increased \$543,000, or 9.03%, from \$6,010,000 in fiscal 2003 to \$6,553,000 in fiscal 2004. The increase was due primarily to increased investments in government agency securities, offset by lower volumes of mortgage-backed securities.

Interest Expense

Interest expense decreased 16.73% to \$7,246,000 for fiscal 2004 from \$8,702,000 for fiscal 2003. Interest expense decreased \$757,000 for deposits and decreased \$699,000 for other borrowings and floating rate junior subordinated deferrable interest debentures. Interest expense for deposits decreased due primarily to lower deposit rates from a declining interest rate environment. In addition, the Corporation increased lower-cost transaction account balances by 29.0% while traditional higher-cost certificate of deposit account balances decreased 4.68%. The overall increase in deposits was primarily from the Rock Hill, South Carolina banking center that was established in late 2003. Interest expense on other borrowings decreased due to lower interest rates during the year, offset by a higher level of borrowings that were utilized to fund growth.

Provision for Loan Loss

Provisions for loan losses are charges to earnings to bring the total allowance for loan losses to a level considered by management as adequate to provide for estimated loan losses based on management's evaluation of the collectibility of the loan portfolio. The provision for loan loss calculation includes a segmentation of loan categories subdivided by residential mortgage, commercial and consumer loans.

Each category is risk rated for all loans including performing groups. The weight assigned to each performing group is developed from a three-year historical average loan loss experience ratio and as the loss experience changes, the category weight is adjusted accordingly. In addition to loan loss experience, management's evaluation of the loan portfolio includes the market value of the underlying collateral, growth and composition of the loan portfolio, delinquency trends and economic conditions. Management evaluates the carrying value of loans periodically, and the allowance for loan losses is adjusted accordingly. The increased provision reflects the Corporation's continued movement from longer term, fixed rate residential loans to shorter term, floating rate consumer and commercial loans. Consumer and commercial loans carry higher risk weighted rates in the reserve calculation as compared to residential mortgage loans. The provision for loan losses increased from \$725,000 in fiscal 2003 to \$1,250,000 in fiscal 2004. The net allowance for loan losses increased \$184,000 to \$2,026,000 as of December 31, 2004 compared to \$1,842,000 as of September 30, 2003. Non-performing loans decreased \$2,304,000 from \$3,054,000 at September 30, 2003 to \$750,000 at December 31, 2004. At December 31, 2004, impaired loans totaled \$197,000 compared to \$718,000 at September 30, 2003.

The Corporation experienced bad debt charge-offs, net of recoveries, of approximately \$1,607,000 in the year ended December 31, 2004 compared to \$254,000 for the year ended September 30, 2003. The bad debt charge-offs for the current year included approximately \$1,306,000 from three commercial loans that were charged off after the loans were determined to be uncollectible. The allowance for loan losses to total loans at December 31, 2004 was 1.18% compared to 1.19% at September 30, 2003. The allowance for loan losses to non-performing loans at December 31, 2004 was 270.13% compared to 60.32% at September 30, 2003.

Non-Interest Income

Non-interest income increased 1.97% to \$2,583,000 for the year ended December 31, 2004 from \$2,533,000 for the year ended September 30, 2003. Service charges and fees increased \$305,000 to \$2,399,000, primarily due to higher fees for financial services related to checking account products along with the growth of the Rock Hill banking center that was opened in the third quarter of 2003. Loan servicing fee income increased \$277,000 to \$65,000 for the year ended December 31, 2004 from \$(212,000) for the year ended September 30, 2003. The increase in loan servicing fees was due to the amortization of servicing expense with all costs being fully amortized in the previous year.

Mortgage banking fees from the gain on sale of loans for the year ended December 31, 2004 was \$95,000 compared to \$40,000 for the year ended September 30, 2003 as the Corporation sold \$10,215,000 in fixed rate mortgage loans during the year as part of its interest rate risk strategies. The sales represent loans funded and sold through a third party on a servicing released basis. Gain on sale of investments was \$24,000 for the year ended December 31, 2004 compared to \$611,000 for the year ended September 30, 2003. The gain on sale of investments for the previous year was the result of the sale of investments with higher interest rate sensitivity, which helped to improve the interest rate risk exposure for the Corporation.

Non-Interest Expense

Non-interest expense increased 7.39% to \$8,162,000 for the year ended December 31, 2004 from \$7,600,000 for the year ended September 30, 2003. On June 16, 2003, the Corporation opened its York County regional banking center and, therefore, expense categories for 2004 reflect additions for the new banking center. Compensation and employee benefits increased 9.20%, or \$317,000, from the year ended September 30, 2003 compared to the year ended December 31, 2004 due primarily to the staff additions for the new branch. Occupancy and equipment expenses increased 6.17%, or \$118,000, to \$2,032,000 for the year ended December 31, 2004 from \$1,914,000 for the year ended September 30, 2003 due to higher rent expense for the new branch. Professional services expense decreased 18.57%, or \$70,000, from the year ended September 30, 2003 to the year ended December 31, 2004 due to lower legal expense as a result of the previous year costs including expenses for the Corporation's conversion to a national bank charter. Advertising and public relations expense decreased 23.11%, or \$49,000, from the year ended September 30, 2003 to the year ended December 31, 2004 due to the previous year promotional costs incurred related to the new banking center opening. Real estate operations costs increased \$77,000, or 132.76%, to \$135,000 for the twelve months ended December 31, 2004 from \$58,000 for the twelve months ended September 30, 2003, due to higher disposition costs associated with foreclosed real estate properties. Items processing expense increased \$28,000, or 12.56%, to \$251,000 for the twelve months ended December 31, 2004 from \$223,000 for the twelve months ended September 30, 2003, due to an increase in demand accounts. Telephone expense increased \$26,000, or 21.31%, to \$148,000 for the twelve months ended December 31, 2004 from \$122,000 for the year ending September 30, 2003 due primarily to the new branch opening. Other operating expense increased 20.38%, or \$118,000, for the year ended December 31, 2004 compared to the year ended September 30, 2004 due primarily to higher general expenses that resulted from the new branch opening in York County.

Income Tax Expense

The effective income tax rate for the Corporation was 25.06% for the twelve month period ended December 31, 2004 compared to 23.50% for the year ended September 30, 2003. The increase was due to the higher level of taxable versus to non-taxable income for the year ended December 31, 2004 compared to the year ended September 30, 2003.

Comparison of Three Months Ended December 31, 2003 and December 31, 2002**General**

In conjunction with the change from a thrift to a commercial banking charter that was granted on July 27, 2003, the Board of Directors of Union Financial Bancshares, Inc. on October 21, 2003, changed the fiscal year end of the Corporation from September 30 to December 31, effective December 31, 2003. Accordingly, the consolidated condensed financial statements are presented for the transition period from October 1, 2003 to December 31, 2003.

During the three months ended December 31, 2003, the Corporation initiated a balance sheet restructuring that was designed to increase the net interest margin and enhance future earnings. The restructuring included the sale of \$31.3 million in low yielding mortgage backed securities that resulted in a pretax loss of \$700,000 and the prepayment of a \$5 million, 6.25% Federal Home Loan advance with two years remaining that carried a \$381,000 penalty. The purpose of the restructuring was to lessen exposure to interest rate risk. Primarily as a result of the Bank's balance sheet restructuring, the Corporation recorded a net loss of \$1,210,000 for the three months ended December 31, 2003.

Interest Income

Interest income decreased \$540,000, or 12.48%, for the three months ended December 31, 2003 as compared to the same period in 2002. Interest income on loans decreased by 16.33%, or \$475,000, due primarily to declining market interest rates along with a smaller average balance of loans. Interest and dividends on investment and mortgage-backed securities decreased \$80,000, or 5.66%, due primarily to the balance sheet restructuring during the period where approximately \$31 million in mortgage-backed securities with a weighted average yield of 2.28% were sold at a pretax loss of \$700,000 and reinvested in mortgage-backed and agency securities with a weighted average yield of approximately 4%.

Interest Expense

Interest expense increased \$22,000, or 0.96%, for the three months ended December 31, 2003 as compared to the three months ended December 31, 2002. As part of the balance sheet restructuring that occurred during the three months ended December 31, 2003, the Corporation prepaid a Federal Home Loan Bank advance that carried a \$381,000 penalty. Interest expense on deposit accounts decreased \$198,000, or 16.11%, to \$1,031,000 for the three months ended December 31, 2003 as the Corporation continued to move toward lower cost demand deposit accounts from traditional thrift higher cost certificate of deposits. Interest expense on borrowings increased \$233,000, or 24.76%, due primarily to the prepayment penalty of \$381,000 partially offset by lowering borrowing costs.

Provision for Loan Loss

During the three months ended December 31, 2003, the provision for loan losses was \$725,000 as compared to \$180,000 for the same period in the previous year due to higher non-accrual loans, an increase in classified assets and the Corporation's continued movement from longer term, fixed rate residential mortgage loans to shorter term, floating rate consumer and commercial loans. Consumer and commercial loans carry higher risk weighted rates in the reserve calculation as compared to residential mortgage loans. Management believes the Corporation's loan loss allowance is adequate to absorb probable loan losses inherent in the portfolio. The Corporation's loan loss allowance at December 31, 2003 was approximately 1.51% of the Corporation's outstanding loan portfolio and 80.85% of non-performing loans compared to .93% of the Corporation's outstanding loan portfolio and 68.32% of non-performing loans at December 31, 2002.

Non-Interest Income

Total non-interest income decreased \$859,000, or 195.23%, to (\$419,000) for the three months ended December 31, 2003 compared to \$440,000 for the three months ended December 31, 2002 due primarily to a loss on the sale of securities of \$700,000. Fees from financial services decreased \$24,000, or 5.37%, due primarily to a reduction in service charge income for the quarter. Loan servicing costs increased \$75,000, or 111.94%, for the three months ended December 31, 2003 due to higher loan prepayment speeds. In addition, the Corporation expensed the remaining servicing rights during the period as part of its transition from a traditional thrift to a commercial bank. The loss on sale of investments of \$700,000 for the three months ended December 31, 2003 was part of the balance sheet restructuring that occurred during the period.

Non-Interest Expense

For the three months ended December 31, 2003, total non-interest expense increased \$495,000, or 29.20% compared to the same period of the prior year. On June 16, 2003, the Corporation opened the new York County regional banking center and therefore, expense categories reflect additions for the new banking center. Compensation and employee benefits increased \$232,000, or 30.97%, for the three month period due primarily to staff additions resulting from the new branch opening. Occupancy and equipment expense increased \$110,000, or 27.03%, for the three months ended December 31, 2003 due to higher depreciation and rent expense due to the new office. Professional services expense decreased \$20,000, or 17.86%, due to lower legal expenses as a result of previous year costs incurred from the Bank's charter change to a national bank charter. Advertising expense increased \$36,000, or 85.71%, for the three months ended December 31, 2003 due to ongoing promotional cost incurred related to the new banking center opening. Real estate operations costs increased \$48,000, or 228.57%, for the three months ended December 31, 2003 due to higher disposition costs associated with foreclosed real estate properties. Other expense increased \$92,000, or 46.94%, for the three months ended December 31, 2003 due primarily to higher telephone, office supplies, and postage expense that resulted from the new office opening in York County.

Comparison of Years Ended September 30, 2003 and September 30, 2002General

Net income increased \$115,000 from \$1,744,000 in fiscal 2002 to \$1,859,000 in fiscal 2003. Earnings per share were \$.95 per share (basic) and \$.90 per share (diluted) for the year ended September 30, 2003 compared to \$.90 per share (basic) and \$.86 per share (diluted) for the same period in 2002. The increase in net income was due to higher non interest income as a result of higher fees from financial services and higher gain on sale of investments.

Interest Income

Total interest income decreased \$1,437,000, or 7.83%, from \$18,361,000 in fiscal 2002 to \$16,924,000 in fiscal 2003. Interest income on loans decreased \$1,605,000, or 12.82%, from \$12,519,000 in fiscal 2002 to \$10,914,000 in fiscal 2003 due primarily to the reduction of loan rates as a result of the declining interest rate environment that was experienced during the prior two fiscal years along with lower net loan growth. The Corporation's continued focus on variable and primed-based lending resulted in net growth in consumer/commercial loans of 37.38% while net residential mortgage loans declined 30.80%. Interest income on investment and mortgage-backed securities increased \$168,000, or 2.88%, from \$5,842,000 in fiscal 2002 to \$6,010,000 in fiscal 2003. The increase was due primarily to purchases of investment and mortgage-backed securities made during the current fiscal year, offset by lower rates due to a lower market interest rate environment.

Interest Expense

Interest expense decreased 10.98% to \$8,702,000 for fiscal 2003 from \$9,775,000 for fiscal 2002. Interest expense decreased \$1,341,000 for deposits and increased \$268,000 for other borrowings and trust preferred corporate obligations. Interest expense for deposits decreased due primarily to lower deposit rates from a declining interest rate environment. In addition, the Corporation increased lower-cost transaction account balances by 9.6% while traditional higher-cost certificate of deposit account balances increased 10.4%. The growth in deposits was primarily due to a new branch opening in Rock Hill, South Carolina. Interest expense on other borrowings increased due to a higher level of borrowings that were utilized to fund growth, offset by lower interest rates during the fiscal year.

Provision for Loan Loss

The provision for loan losses decreased from \$990,000 in fiscal 2002 to \$725,000 in fiscal 2003, which reflected in part the net decrease in the loan portfolio of \$8,655,000, or 5.36%, from September 30, 2002 to September 30, 2003 and a reduction in net charge-offs. The allowance for loan losses, net, increased \$471,000 to \$1,842,000 at September 30, 2003 compared to \$1,371,000 at September 30, 2002. Non-performing loans increased \$1,188,000 from \$1,866,000 at September 30, 2002 to \$3,054,000 at September 30, 2003. The net increase for fiscal 2003 included one loan of \$1,087,000 that is well secured by commercial real estate and improvements. At September 30, 2003 and 2002, impaired loans totaled \$718,246 and \$809,293 respectively. See Note 3 of consolidated financial statements for an analysis of loans.

The Corporation experienced bad debt charge-offs, net of recoveries, of approximately \$254,000 in fiscal 2003 compared to \$699,000 for fiscal 2002. The bad debt charge-offs from the previous year included approximately \$500,000 from one commercial loan that was written down to the fair market value as a result of a reassessment of underlying collateral. The allowance for loan losses to total loans at the end of fiscal 2003 was 1.19% compared to 0.83% at the end of fiscal 2002. The allowance for loan losses to non-performing loans at the end of fiscal 2003 was 60.32% compared to 73.47% at the end of fiscal 2002.

Non-Interest Income

Non-interest income increased 50.50% to \$2,533,000 for the year ended September 30, 2003 from \$1,683,000 for the year ended September 30, 2002. Service charges and fees increased \$207,000 to \$2,094,000, primarily due to the development of new fee income programs. Loan servicing fee costs increased \$45,000 to \$(212,000) for the year ended September 30, 2003 from \$(167,000) for the year ended September 30, 2002. Higher loan prepayments during fiscal years 2002 and 2003 resulted in servicing rights amortization expense exceeding service fee income. Loan servicing amortization expense decreased \$36,000 to \$314,000 for the year ended September 30, 2003 from \$350,000 for the year ended September 30, 2002 while loan servicing income decreased \$81,000 to \$102,000 for the year ended September 30, 2003 from \$183,000 for the year ended September 30, 2002. The amortization expense of mortgage servicing rights was higher than related servicing income due to the relatively small amount of loans serviced during the period and due to higher loan prepayments as a result of the low interest rate environment. The higher prepayments were reflected in the increased amortization of mortgage servicing rights. The Corporation did not record any servicing rights impairment expense during fiscal years 2003 or 2002. Gain (loss) on sale of investments increased \$688,000 to \$651,000 during the year ended September 30, 2003 from \$(37,000) for the year ended September 30, 2002. The gain on sale of investments for the year was the result of the sale of investments with higher interest rate sensitivity, which was expected to improve interest rate exposure for the Corporation.

Non-Interest Expense

Non-interest expense increased 8.93% to \$7,600,000 in fiscal 2003 from \$6,977,000 in fiscal 2002. The increase in non-interest expense reflected the startup costs for a new branch opening in Rock Hill, South Carolina during the third quarter of fiscal 2003. Compensation and employee benefits increased 13.78% or \$417,000 from fiscal 2002 to fiscal 2003 due primarily to the staff additions as a result of the new branch opening. Occupancy and equipment expenses increased 13.39%, or \$226,000, from fiscal 2002 to fiscal 2003 due to higher depreciation and equipment expense as a result of the new branch opening. Professional services expense increased 8.33%, or \$29,000, from fiscal 2002 to fiscal 2003 due to higher audit and legal expenses. Advertising and public relations expense increased 61.83%, or \$81,000, from fiscal 2002 to fiscal 2003 due to higher expenses required for the new branch opening. Other operating expense decreased 10.09%, or \$65,000, from fiscal 2002 to fiscal 2003 due to reductions in general operating expenses.

Income Tax Expense

The overall effective income tax rate for the Corporation was 23.50% for the twelve month period ended September 30, 2003 compared to 24.24% for the same period in 2002. The reduction was due to increased investments in government municipal securities totaling \$21,780,000 at September 30, 2003 compared to \$14,597,000 at September 30, 2002.

Financial Condition, Liquidity and Capital ResourcesFinancial ConditionAssets

At December 31, 2004, the Corporation's assets totaled \$351,598,000, an increase of \$19,714,000, or 5.94%, as compared to \$331,884,000 at December 31, 2003. Short term interest earning deposits decreased \$15,576,000 to \$11,611,000 from \$27,187,000 at December 31, 2003. The reduction in short term interest earning deposits was utilized to fund growth in investment securities and loans. Investment and mortgage-backed securities increased \$19,705,000 to \$143,494,000 from \$123,789,000 at December 31, 2003. All securities being purchased have adjustable features and will, therefore, have increasing interest rates in a rising market.

Total loans, net, increased \$16,593,000, or 10.74%, to \$171,094,000 from \$154,501,000 at December 31, 2003. The net change in the loan portfolio balance includes a reduction in residential mortgage loans that reflects the Corporation's movement toward higher yielding consumer and commercial loans that are intended to provide improvements in interest rate risk exposure. Consumer and commercial loans outstanding during this period increased \$18,764,000, or 20.55%, while outstanding residential mortgage loans decreased \$2,422,000 or 3.76%.

Liabilities

Total liabilities increased \$19,202,000, or 6.27%, to \$325,579,000 at December 31, 2004 from \$306,377,000 at December 31, 2003.

Total deposits increased \$4,458,000, or 2.00%, from \$223,131,000 at December 31, 2003 to \$227,589,000 at December 31, 2004. The growth was primarily a result of a new branch opening in Rock Hill, South Carolina in the third quarter of fiscal 2003. Borrowings from the Federal

Home Loan Bank (FHLB) decreased \$5,000,000, or 7.30%, to \$63,500,000 at December 31, 2004 from \$68,500,000 at December 31, 2003. Securities sold under agreements to repurchase were \$24,000,000 at December 31, 2004 compared to \$5,000,000 at December 31, 2003. During this period, securities sold under agreement to repurchase provided a lower cost funding alternative to Federal Home Loan Bank advances. The increase in repurchase agreements funded the additional loan growth and security purchases for the year. Other liabilities increased \$468,000, or 33.38%, to \$1,870,000 at December 31, 2004 from \$1,402,000 at December 31, 2003 due primarily to an increase in accrued liabilities.

Shareholders' Equity

Shareholders' equity increased \$512,000, or 2.01%, to \$26,019,000 at December 31, 2004 from \$25,507,000 at December 31, 2003 due to net income of \$2,156,000 and a \$10,000 increase in unrealized gains on securities available for sale reduced by the payment of \$0.40 per share dividends and the cost to repurchase shares. During fiscal year 2003, the Corporation implemented a share repurchase program under which the Corporation may repurchase up to 5% of outstanding shares. The program was expanded by an additional 5% in fiscal 2004. The shares will be repurchased either through open market purchases or privately negotiated transactions and will be made from time to time depending on market conditions and other factors. Repurchased shares will be held in treasury and will be available for the Corporation's benefit plans. The repurchase program is expected to improve the Corporation's operating performance on a per share basis, enhance, in the long term, the market price per share of the Corporation's common stock and increase the liquidity of the Corporation's common stock. During fiscal 2004, the Corporation repurchased a total of 62,699 shares at a weighted average cost of \$17.13 per share for a total of \$1,074,000 compared to a repurchased total of 20,286 shares at a weighted average cost of \$18.04 per share for a total of \$366,073 for fiscal 2003.

Liquidity

Liquidity is the ability to meet demand for loan disbursements, deposit withdrawals, repayment of debt, payment of interest on deposits and other operating expenses. The primary sources of liquidity are savings deposits, loan sales and repayments, borrowings, maturity of securities and interest payments.

While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit outflows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. The primary investing activities of the Corporation are the origination of commercial and consumer loans and the purchase of investment and mortgage-backed securities. These activities are funded primarily by principal and interest payments on loans and investment securities, deposit growth, securities sold under agreements to repurchase, and the utilization of FHLB advances. During the year ended December 31, 2004, the Corporation's loan originations totaled \$73,521,000. At December 31, 2004, the Corporation's investment in investment and mortgage-backed securities totaled \$143,494,000.

During the year ended December 31, 2004, total deposits increased \$4,458,000. Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by the Corporation and its local competitors and other factors. The Corporation closely monitors its liquidity position on a daily basis. Certificates of deposit, which are scheduled to mature in one year or less from December 31, 2004, totaled \$92,334,000. The Corporation relies primarily on competitive rates, customer service, and long-standing relationships with customers to retain deposits. From time to time, the Corporation will also offer competitive special products to its customers to increase retention and to attract new deposits. Based upon the Corporation's experience with deposit retention and current retention strategies, management believes that, although it is not possible to predict future terms and conditions upon renewal, a significant portion of such deposits will remain with the Corporation. If the Corporation requires funds beyond its ability to generate them internally, additional sources of funds are available through FHLB advances and securities sold under agreements to repurchase. At December 31, 2004, the Corporation had \$63,500,000 of FHLB borrowings and \$24,000,000 of securities sold under agreements to repurchase. At December 31, 2004, the Corporation had unused short-term lines of credit to purchase federal funds from unrelated banks totaling \$21,000,000. These lines of credit are available on a one-to-ten day basis for general purposes of the Corporation. All of the lenders have reserved the right to withdraw these lines at their option.

See Note 14 to the consolidated financial statements for further information about commitments and contingencies.

Capital Resources

At December 31, 2004, the Bank exceeded the Comptroller of the Currency's (the "OCC") and the Federal Reserve Bank's (the "FRB") capital requirements. See Note 16 to the consolidated financial statements for further discussion of these capital requirements.

Off-Balance Sheet Risk

In the normal course of operations, the Corporation engages in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded in its financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customer's requests for funding and take the form of legally binding agreements to lend money to customers at predetermined interest rates for a specified period of time. Outstanding loan commitments (including commitments to fund credit lines) totaled \$40,604,000 at December 31, 2004. Management of the Corporation anticipates that it will have sufficient funds available to meet its current loan commitments. Each customer's credit worthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on the credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, commercial and residential real estate. The credit risk on these commitments is managed by subjecting each customer to normal underwriting and risk management processes.

At December 31, 2004, the undisbursed portion of construction loans was \$2,363,000 and the unused portion of credit lines was \$33,479,000. Funding for these commitments is expected to be provided from deposits, loan and mortgage-backed securities principal repayments, maturing investments and income generated from operations.

For the year ended December 31, 2004, the Corporation did not engage in any off-balance sheet transactions reasonably likely to have a material effect on its financial condition, results of operation and cash flows.

Impact of Inflation and Changing Prices

The financial statements and related data presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America, which require the measurement of financial position and operating results in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation. Unlike industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. However, non-interest expenses do reflect general levels of inflation.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors
Union Financial Bancshares, Inc. and Subsidiaries
Union, South Carolina

We have audited the accompanying consolidated balance sheets of **Union Financial Bancshares, Inc. and Subsidiaries** (the "Company") as of December 31, 2004 and 2003, and the related consolidated statements of income, shareholders' equity and comprehensive income, and cash flows for the year ended December 31, 2004, the three months ended December 31, 2003 and the years ended September 30, 2003 and 2002. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **Union Financial Bancshares, Inc. and Subsidiaries** as of December 31, 2004 and 2003 and the results of their operations and their cash flows for the year ended December 31, 2004, the three months ended December 31, 2003 and the years ended September 30, 2003 and 2002, in conformity with accounting principles generally accepted in the United States of America.

/s/ Elliott Davis, LLC

Greenville, South Carolina
January 28, 2005

Union Financial Bancshares, Inc. and Subsidiaries
Consolidated Balance Sheets

As of December 31,

2004 2003

(In Thousands)

Assets

| | | | | |
|--|-----------|----------------|-----------|----------------|
| Cash | \$ | 1,586 | \$ | 1,515 |
| Short term interest-earning deposits | | 11,611 | | 27,187 |
| Total cash and cash equivalents | | 13,197 | | 28,702 |
| Investment and mortgage-backed securities | | | | |
| Held to maturity (\$1,688,000 fair value) | | 1,630 | | — |
| Available for sale (at fair value) | | 141,864 | | 123,789 |
| Total investment and mortgage-backed securities | | 143,494 | | 123,789 |
| Loans, net | | 171,094 | | 154,501 |
| Federal Home Loan Bank Stock, at cost | | 3,522 | | 3,900 |
| Federal Reserve Stock, at cost | | 539 | | 539 |
| Office properties and equipment, net | | 5,635 | | 6,415 |
| Accrued interest receivable | | 2,068 | | 1,655 |
| Intangible assets | | 4,212 | | 4,848 |
| Cash surrender value of life insurance | | 5,206 | | 5,025 |
| Other assets | | 2,631 | | 2,510 |
| Total assets | \$ | 351,598 | \$ | 331,884 |

Liabilities

| | | | | |
|--|----|----------------|----|----------------|
| Deposits | \$ | 227,589 | \$ | 223,131 |
| Advances from the Federal Home Loan Bank and other borrowings | | 63,500 | | 68,500 |
| Securities sold under agreements to repurchase | | 24,000 | | 5,000 |
| Floating rate junior subordinated deferrable interest debentures | | 8,247 | | 8,000 |
| Accrued interest payable | | 333 | | 285 |
| Other liabilities | | 1,910 | | 1,461 |
| Total liabilities | | 325,579 | | 306,377 |

Commitments and contingencies - note 14

Shareholders' equity

| | | | | |
|---|-----------|----------------|-----------|----------------|
| Serial preferred stock, no par value, authorized - 500,000 shares, issued and outstanding - None | | | | |
| Common stock - \$0.01 par value, authorized - 2,500,000 shares issued and outstanding - 1,957,989 shares at December 31, 2004 and 1,969,770 shares at December 31, 2003 | | 20 | | 20 |
| Additional paid-in capital | | 12,109 | | 11,906 |
| Accumulated other comprehensive income | | 109 | | 99 |
| Retained earnings, substantially restricted | | 15,221 | | 13,848 |
| Treasury stock, at cost | | (1,440) | | (366) |
| Total shareholders' equity | | 26,019 | | 25,507 |
| Total liabilities and shareholders' equity | \$ | 351,598 | \$ | 331,884 |

See notes to consolidated financial statements.

Union Financial Bancshares, Inc. And Subsidiaries
Consolidated Statements of Income

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|--|------------------------------------|---|---------------------------|-----------------|
| | | | 2003 | 2002 |
| (In Thousands, Except Share Data) | | | | |
| Interest Income: | | | | |
| Loans | \$ 10,399 | \$ 2,433 | \$ 10,914 | \$ 12,519 |
| Deposits and federal funds sold | 40 | 21 | 23 | 85 |
| Securities available for sale: | | | | |
| State and municipal (non taxable) | 930 | 251 | 881 | 731 |
| Other investments (taxable) | 5,400 | 1,052 | 4,952 | 4,868 |
| Securities held to maturity and FHLB/FRB stock dividends | 183 | 30 | 154 | 158 |
| Total interest income | 16,952 | 3,787 | 16,924 | 18,361 |
| Interest Expense: | | | | |
| Deposit accounts | 3,903 | 1,031 | 4,660 | 6,001 |
| Floating rate junior subordinated deferrable interest debentures | 426 | 100 | 415 | 365 |
| Advances from the FHLB and other | 2,917 | 1,174 | 3,627 | 3,409 |
| Total interest expense | 7,246 | 2,305 | 8,702 | 9,775 |
| Net-Interest Income | 9,706 | 1,482 | 8,222 | 8,586 |
| Provision for loan losses | 1,250 | 725 | 725 | 990 |
| Net interest income after provision for loan losses | 8,456 | 757 | 7,497 | 7,596 |
| Non-Interest Income: | | | | |
| Fees for financial services | 2,399 | 559 | 2,094 | 1,887 |
| Loan servicing fees, (costs) net of servicing amortization | 65 | (142) | (212) | (167) |
| Net gain (loss) on sale of investment transactions | 24 | (695) | 611 | (37) |
| Net gain (loss) on sale of loans | 95 | (5) | 40 | — |
| Total non-interest income | 2,583 | (283) | 2,533 | 1,683 |
| Non-Interest Expense: | | | | |
| Compensation and employee benefits | 3,761 | 1,014 | 3,444 | 3,027 |
| Occupancy and equipment | 2,032 | 550 | 1,914 | 1,688 |
| Deposit insurance premiums | 32 | 6 | 35 | 34 |
| Professional services | 307 | 92 | 377 | 348 |
| Advertising and public relations | 163 | 78 | 212 | 131 |
| Real estate operations | 135 | 69 | 58 | 69 |
| Telephone | 148 | 49 | 122 | 137 |
| Items Processing | 251 | 59 | 223 | 240 |
| Intangible amortization | 636 | 159 | 636 | 659 |
| Other | 697 | 250 | 579 | 644 |
| Total non-interest expense | 8,162 | 2,326 | 7,600 | 6,977 |
| Income (Loss) before income taxes | 2,877 | (1,852) | 2,430 | 2,302 |
| Provision (benefit) for income taxes | 721 | (642) | 571 | 558 |
| Net Income (Loss) | \$ 2,156 | (\$ 1,210) | \$ 1,859 | \$ 1,744 |
| Net Income (Loss) per common share (Basic) | \$ 1.10 | (\$ 0.62) | \$ 0.95 | \$ 0.90 |

| | | | | |
|--|-----------|-----------|-----------|-----------|
| Net Income (Loss) per common share (Diluted) | \$ 1.05 | (\$ 0.62) | \$ 0.90 | \$ 0.86 |
| Cash dividends per common share | \$ 0.40 | \$ 0.10 | \$ 0.40 | \$ 0.40 |
| Weighted average number of common shares outstanding (Basic) | 1,957,760 | 1,967,217 | 1,963,775 | 1,939,084 |
| Weighted average number of common shares outstanding (Diluted) | 2,044,137 | 1,967,217 | 2,056,579 | 2,030,040 |

See notes to consolidated financial statements.

Union Financial Bancshares, Inc. And Subsidiaries
Consolidated Statements of Shareholders' equity and Comprehensive Income

| | Common Stock | | Additional Paid-In Capital | Retained Earnings Substantially Restricted | Accumulated Other Comprehensive Income (Loss) | Treasury Stock At Cost | Total Shareholders' Equity |
|--|--------------|--------|----------------------------------|---|--|------------------------------|----------------------------------|
| | Shares | Amount | | | | | |
| <i>(In Thousands, Except Share Data)</i> | | | | | | | |
| Balance at September 30, 2001 | 1,924,478 | \$ 20 | \$ 11,321 | \$ 13,217 | (\$ 182) | \$ — | \$ 24,376 |
| Net income | — | — | — | 1,744 | — | — | 1,744 |
| Unrealized holding gains arising during period | — | — | — | — | 1,621 | — | 1,621 |
| Less reclassification adjustment for losses included in net income | — | — | — | — | (18) | — | (18) |
| Comprehensive income | | | | | | | 3,347 |
| Stock option activity | 23,605 | — | 141 | — | — | — | 141 |
| Dividend reinvestment plan contributions | 9,986 | — | 111 | — | — | — | 111 |
| Cash dividend (\$.40 per share) | — | — | — | (777) | — | — | (777) |
| Balance at September 30, 2002 | 1,958,069 | \$ 20 | \$ 11,573 | \$ 14,184 | \$ 1,421 | \$ — | \$ 27,198 |
| Net income | — | — | — | 1,859 | — | — | 1,859 |
| Other comprehensive income, net of tax Unrealized holding losses arising during period | — | — | — | — | (2,443) | — | (2,443) |
| Less reclassification adjustment for gains included in net income | — | — | — | — | 467 | — | 467 |
| Comprehensive loss | | | | | | | (117) |
| Stock option activity | 19,889 | — | 179 | — | — | — | 179 |
| Dividend reinvestment plan contributions | 7,431 | — | 110 | — | — | — | 110 |
| Share repurchase program | (20,286) | — | — | — | — | (366) | (366) |
| Cash dividend (\$.40 per share) | — | — | — | (788) | — | — | (788) |
| Balance at September 30, 2003 | 1,965,103 | \$ 20 | \$ 11,862 | \$ 15,255 | (\$ 555) | (\$ 366) | \$ 26,216 |

Union Financial Bancshares, Inc. And Subsidiaries
Consolidated Statements of Shareholders' equity and Comprehensive Income (continued)

| | Common Stock | | Additional Paid-In Capital | Earnings Substantially Restricted | Other Comprehensive Income (Loss) | Retained Treasury Stock At Cost | Accumulated Total Shareholder's Equity |
|--|--------------|--------|----------------------------------|---|---|--|---|
| | Shares | Amount | | | | | |
| (In Thousands, Except Share Data) | | | | | | | |
| Balance at September 30, 2003 | 1,965,103 | \$ 20 | \$ 11,862 | \$ 15,255 | (\$ 555) | (\$ 366) | \$ 26,216 |
| Net loss | — | — | — | (1,210) | — | — | (1,210) |
| Other comprehensive income, net of tax | | | | | | | |
| Unrealized holding gains arising during period | — | — | — | — | 1,108 | — | 1,108 |
| Less reclassification adjustment for losses included in net income | — | — | — | — | (454) | — | (454) |
| Comprehensive loss | | | | | | | (556) |
| Stock option activity | 3,006 | — | 17 | — | — | — | 17 |
| Dividend reinvestment plan contributions | 1,661 | — | 27 | — | — | — | 27 |
| Cash dividend (\$.10 per share) | — | — | — | (197) | — | — | (197) |
| Balance at December 31, 2003 | 1,969,770 | \$ 20 | \$ 11,906 | \$ 13,848 | \$ 99 | (\$ 366) | \$ 25,507 |
| Net income | — | — | — | 2,156 | — | — | 2,156 |
| Other comprehensive income, net of tax | | | | | | | |
| Unrealized holding losses arising during period | — | — | — | — | (8) | — | (8) |
| Less reclassification adjustment for gains included in net income | — | — | — | — | 18 | — | 18 |
| Comprehensive income | | | | | | | 2,166 |
| Stock option activity, net | 44,174 | — | 93 | — | — | — | 93 |
| Dividend reinvestment plan contributions | 6,744 | — | 110 | — | — | — | 110 |
| Share repurchase program | (62,699) | — | — | — | — | (1,074) | (1,074) |
| Cash dividend (\$.40 per share) | — | — | — | (783) | — | — | (783) |
| Balance at December 31, 2004 | 1,957,989 | \$ 20 | \$ 12,109 | \$ 15,221 | \$ 109 | (\$ 1,440) | \$ 26,019 |

See notes to consolidated financial statements.

Union Financial Bancshares, Inc. And Subsidiaries
Consolidated Statements of Cash Flows

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|--|------------------------------------|---|------------------------------|-----------------|
| | | | 2003 | 2002 |
| Operating activities: | | | | |
| Net income(loss) | \$ 2,156 | (\$1,210) | \$ 1,859 | \$ 1,744 |
| Adjustments to reconcile net income(loss) to net cash provided by operating activities: | | | | |
| Provision for loan losses | 1,250 | 725 | 725 | 990 |
| Amortization expense | 636 | 159 | 1,176 | 1,008 |
| Depreciation expense | 979 | 264 | 1,048 | 895 |
| Recognition of deferred income, net of costs | (345) | (37) | (137) | (115) |
| Deferral of fee income, net of costs | 348 | 22 | 152 | 195 |
| (Gain) loss on investment transactions | (119) | 700 | (652) | 37 |
| (Increase) decrease in accrued interest receivable | (413) | 272 | (199) | 99 |
| (Increase) decrease in other assets | (55) | 1,267 | (2,496) | (91) |
| (Decrease) increase in accrued interest payable | 48 | (79) | (63) | 23 |
| (Decrease) increase in other liabilities | 449 | (1,251) | 453 | (846) |
| Net cash provided by operating activities | \$ 4,934 | \$ 832 | \$ 1,866 | \$ 3,939 |

Union Financial Bancshares, Inc. And Subsidiaries
Consolidated Statements of Cash Flows (continued)

| | Year Ended December 31, 2004 | Three Months December 31, 2003 | Ended September 30, | |
|--|------------------------------------|---|------------------------|-----------------|
| | | | 2003 | 2002 |
| Investing activities: | | | | |
| Purchase of investment and mortgage-backed securities: | | | | |
| Held to maturity | (\$ 1,630) | \$ — | \$ — | \$ — |
| Available for sale | (109,482) | (5,654) | (165,521) | (89,841) |
| Proceeds from maturity of investment and mortgage-backed securities: | | | | |
| Available for sale | 70,594 | 91 | 47,071 | 6,304 |
| Proceeds from sale of investment and mortgage-backed securities: | | | | |
| Held to maturity | — | — | — | 18,000 |
| Available for sale | 4,702 | 30,187 | 33,672 | 21,806 |
| Principal repayments on mortgage-backed securities: | | | | |
| Held to maturity | — | — | — | 605 |
| Available for sale | 16,240 | 9,025 | 42,997 | 14,610 |
| Net (increase) decrease in loans | (17,846) | (1,726) | 8,566 | (3,513) |
| (Purchase) Redemption of FHLB/FRB stock | 378 | — | (1,539) | (275) |
| Purchase of office properties and equipment | (199) | (316) | (890) | (204) |
| Net cash provided by (used in) investing activities | (37,243) | 31,607 | (35,644) | (32,508) |
| Financing activities: | | | | |
| Proceeds from the exercise of stock options | 93 | 17 | 179 | 141 |
| Proceeds from dividend reinvestment plan | 110 | 27 | 110 | 111 |
| Dividends paid in cash | (783) | (197) | (788) | (777) |
| Proceeds (repayment) of term borrowings, net | 14,000 | (11,500) | 11,000 | 16,993 |
| Proceeds from issuance of floating rate junior subordinated deferrable interest debentures | — | — | — | 8,000 |
| Share repurchase program | (1,074) | — | (366) | — |
| Increase in deposit accounts | 4,458 | 2,899 | 19,929 | 6,224 |
| Net cash provided by (used in) financing activities | 16,804 | (8,754) | 30,064 | 30,692 |
| Net (decrease) increase in cash and cash equivalents | (15,505) | 23,685 | (3,714) | 2,123 |
| Cash and cash equivalents at beginning of year | 28,702 | 5,017 | 8,731 | 6,608 |
| Cash and cash equivalents at end of year | \$ 13,197 | \$ 28,702 | \$ 5,017 | \$ 8,731 |

See notes to consolidated financial statements.

Union Financial Bancshares, Inc. and Subsidiaries
Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

Organization - Union Financial Bancshares, Inc. ("Union Financial") is the bank holding company for Provident Community Bank, N.A., a national bank ("the Bank"), (the "Corporation"). The Bank, founded in 1934, offers a complete array of financial services through seven full service banking centers in four counties in South Carolina, including checking, savings, time deposits, individual retirement accounts (IRAs), investment services, and secured and unsecured consumer loans. The Bank originates and services home loans and provides financing for small businesses and affordable housing. Provident Financial Services ("PFS") is a wholly-owned subsidiary of the Bank that provides investment brokerage services. In conjunction with the change from a savings bank charter regulated by the Office of Thrift Supervision ("OTS") to a commercial banking charter regulated by the Comptroller of the Currency ("OCC") that was granted on July 27, 2003, the Board of Directors of Union Financial Bancshares, Inc. on October 21, 2003, changed the fiscal year end of the Corporation from September 30 to December 31, effective December 31, 2003. Accordingly, the consolidated condensed financial statements are presented for the transition period from October 1, 2003 to December 31, 2003.

Accounting Principles - The accounting and reporting policies of the Corporation conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of commitments and contingencies. Actual results could differ from those estimates. The following summarizes the more significant policies.

Basis of Consolidation - The accompanying consolidated financial statements include the accounts of Union Financial and its wholly owned subsidiaries, the Bank, and the Bank's wholly owned subsidiary, PFS. All intercompany amounts and balances have been eliminated in consolidation.

Cash and Cash Equivalents - Cash and cash equivalents include cash on hand and amounts due from depository institutions, federal funds sold and short term, interest-earning deposits. From time to time, the Corporation's cash deposits with other financial institutions may exceed the FDIC insurance limits.

Investments and Mortgage-backed Securities - The Corporation accounts for investment securities in accordance with Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities". In accordance with SFAS 115, debt securities that the Corporation has the positive intent and ability to hold to maturity are classified as "held to maturity" securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling in the near term are classified as "trading" securities and reported at fair value, with unrealized gains and losses included in earnings. Debt and equity securities not classified as either held to maturity or trading securities are classified as "available for sale" securities and reported at fair value with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity. No securities have been classified as trading securities.

Purchases and sales of securities are accounted for on a trade date basis. Premiums and discounts on debt securities are amortized or accreted as adjustments to income over the estimated life of the security using a method approximating the level yield method. Gains or losses on the sale of securities are based on the specific identification method. The fair value of securities is based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans - Loans held for investment are recorded at cost. Mortgage loans consist principally of conventional one-to four-family residential loans and interim and permanent financing of non-residential loans that are secured by real estate. Commercial loans are made primarily on the strength of the borrower's general credit standing, the ability to generate repayment from income sources and the collateral securing such loans. Consumer loans generally consist of home equity loans, automobile and other personal loans. In many lending transactions, collateral is taken to provide an additional measure of security. Generally, the cash flow or earning power of the borrower represents the primary source of repayment, and collateral liquidation serves as a secondary source of repayment. The Corporation determines the need for collateral on a case-by-case or product-by-product basis. Factors considered include the current and prospective credit worthiness of the customer, terms of the instrument and economic conditions.

The Corporation generally originates single-family residential loans within its primary lending area. The Corporation's underwriting policies require such loans to be 80% loan to value based upon appraised values unless private mortgage insurance is obtained. These loans are secured by the underlying properties. Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are stated at the amount of unpaid principal, reduced by unearned discount and fees and an allowance for loan losses. Unearned interest on loans is amortized to income over the life of the loan, using the interest method. For all other loans, interest is accrued daily on the outstanding balances.

Loan origination and commitment fees and certain direct loan origination costs are deferred and the net amount amortized as an adjustment of the related loan's yield. The Corporation is generally amortizing these amounts over the contractual life. Commitment fees and costs are generally based upon a percentage of a customers' unused line of credit and are recognized over the commitment period when the likelihood of exercise is remote. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise is recognized over the life of the loan as an adjustment of the yield.

1. Summary of Significant Accounting Policies (continued)

For impaired loans, accrual of interest is discontinued on a loan when management believes, after considering collection efforts and other factors, that the borrower's financial condition is such that collection of interest is doubtful. Cash collections on impaired loans are credited to the loan receivable balance, and no interest income is recognized on those loans until the principal balance has been collected.

The Corporation determines a loan to be delinquent when payments have not been made according to contractual terms, typically evidenced by nonpayment of a monthly installment by the due date. The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent.

All interest accrued but not collected for loans that are placed on non accrual status or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowances for Estimated Losses - The Corporation maintains allowances for estimated loan losses and losses on real estate acquired in settlement of loans. Loss provisions are charged to income when, in the opinion of management, such losses for which no provision has been made are probable.

The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that collectibility of the principal is unlikely. Subsequent recoveries, if any, are credited to the allowance.

The allowance is an amount that management believes will be adequate to absorb estimated losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio, based on an evaluation of the collectibility of existing loans and prior loss experience. This evaluation also takes into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to pay. The allowance for loan loss calculation includes a segmentation of loan categories by residential mortgage, commercial and consumer loans. Each category is rated for all loans. The weights assigned to each performing group are developed from previous loan loss experience and as the loss experience changes, the category weight is adjusted accordingly. In addition, as the loan categories increase and decrease in balance, the provision for loan loss calculation will adjust accordingly. The evaluation also includes the effects of factor reserves for expected losses on groups of loans that are related to future events or expected changes in economic conditions. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses, and may require the Corporation to make additions to the allowance based on their judgement about information available to them at the time of their examinations.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also accounted for as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is impaired when it is probable, based on current information, the Corporation will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Impaired loans are measured on an individual basis for commercial and construction loans based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. The amount of impairment, if any, and any subsequent changes are included in the allowance for loan losses. Large groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual residential loans for impairment disclosures.

Recovery of the carrying value of loans is dependent to some extent on the future economic environment and operating and other conditions that may be beyond the Corporation's control. Unanticipated future adverse changes in such conditions could result in material adjustments to allowances (and future results of operation).

Accounting for Impaired Loans - Impaired loans are accounted for in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan" SFAS No. 114 requires that impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical matter, at the loan's observable market value or fair value of the collateral if the loan is collateral dependent. If the resulting value of the impaired loan is less than the recorded balance, the impairment must be recognized by creating a valuation allowance for the difference and recognizing a corresponding bad debt expense. The risk characteristics used to aggregate loans are collateral type, borrower's financial condition and geographic location. SFAS No. 118, "Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures", amends SFAS No. 114 to allow a creditor to use existing methods for recognizing interest income on an impaired loan and requires additional disclosures about how a creditor recognizes interest income related to impaired loans.

1. Summary of Significant Accounting Policies (continued)

The Corporation generally determines a loan to be impaired at the time management believes that it is probable that the principal and interest may be uncollectible. Management has determined that, generally, a failure to make a payment within a 90-day period constitutes a minimum delay or shortfall and does not generally constitute an impaired loan. However, management reviews each past due loan and may determine a loan to be impaired prior to the loan becoming over 90 days past due, depending upon the circumstances of that particular loan. A loan is classified as a non-accrual loan at the time management believes that the collection of interest is improbable, generally when a loan becomes 90 days past due. The Corporation's policy for charge-off of impaired loans is on a loan-by-loan basis. At the time management believes the collection of interest and principal is remote, the loan is charged off. The Corporation's policy is to evaluate impaired loans based on the fair value of the collateral. Interest income from impaired loans is recorded using the cash method.

At December 31 2004 and 2003, impaired loans totaled \$197,000 and \$448,000 respectively, and the Corporation had recognized no interest income from impaired loans. The average balance in impaired loans was \$322,000 for 2004 and \$789,000 for 2003.

Office Properties and Equipment - Office properties and equipment are presented at cost less accumulated depreciation. Depreciation is provided on the straight-line basis over the estimated useful lives of the assets. Estimated useful lives are 20-39 years for buildings and improvements and generally five to ten years for furniture, fixtures and equipment.

The cost of maintenance and repairs is charged to expense as incurred, and improvements and other expenditures, which materially increase property lives, are capitalized. The costs and accumulated depreciation applicable to office properties and equipment retired or otherwise disposed of are eliminated from the related accounts, and any resulting gains or losses are credited or charged to income.

Securities Sold Under Agreements to Repurchase - The Corporation enters into sales of securities under agreements to repurchase. Fixed-coupon reverse repurchase agreements are treated as financings, with the obligations to repurchase securities sold being reflected as a liability and the securities underlying the agreements remaining as an asset. The securities are delivered by appropriate entry by the Corporation's safekeeping agent to the counterparties' accounts. The dealers may have sold, loaned or otherwise disposed of such securities to other parties in the normal course of their operations, and have agreed to resell to the Corporation substantially identical securities at the maturities of the agreements.

Federal Home Loan Bank Stock - The Bank, as a member institution of Federal Home Loan Bank ("FHLB") of Atlanta, is required to own capital stock in the FHLB of Atlanta based generally upon the Bank's balances of residential mortgage loans and FHLB advances. No ready market exists for this stock and it has no quoted market value. However, redemption of this stock has historically been at par value. The Bank carries this investment at its original cost.

Federal Reserve Bank Stock - The Bank, as a member institution of Federal Reserve Bank ("FRB") is required to own capital stock in the FRB based upon the Bank's capital and surplus. No ready market exists for this stock and it has no quoted market value. However, redemption of this stock has historically been at par value. The Bank carries this investment at its original cost.

Real Estate Acquired Through Foreclosure - Real estate acquired through foreclosure is stated at the lower of cost or estimated fair value less estimated costs to sell. Any accrued interest on the related loan at the date of acquisition is charged to operations. Costs relating to the development and improvement of property are capitalized to the extent that such costs do not exceed the estimated fair value less selling costs of the property, whereas those relating to holding the property are charged to expense. Real estate acquired through foreclosure is included in other assets on the balance sheet.

Income Taxes - The Corporation accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". Under SFAS No. 109, deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is established for deferred tax assets that may not be realized. Also, SFAS No. 109 eliminates, on a prospective basis, the exception from the requirement to record deferred taxes on tax basis bad debt reserves in excess of the base year amounts. The tax basis bad debt reserve that arose prior to the fiscal year 1988 (the base year amount) is frozen, and the book reserves at that date and all subsequent changes in book and tax basis reserves are included in the determination of deferred taxes.

Fair Values of Financial Instruments - The following methods and assumptions were used by the Corporation in estimating fair values of financial instruments as disclosed herein:

Cash and short-term instruments - The carrying amounts of cash and short-term instruments approximate their fair value.

Available for sale and held to maturity securities - Fair values for securities are based on quoted market prices. The carrying values of restricted equity securities approximate fair values.

Loans - For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for certain mortgage loans (for example, one-to four-family residential), credit-card loans, and other consumer loans are based on quoted market prices.

1. Summary of Significant Accounting Policies (continued)

of similar loans sold in conjunction with securitization transactions, adjusted for differences in loan characteristics. Fair values for commercial real estate and commercial loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable.

Cash surrender value of life insurance - The carrying amounts of cash surrender values of life insurance approximate their fair value.

Deposit liabilities - The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money-market accounts and certificates of deposit (CDs) approximate their fair values at the reporting date. Fair values for fixed-rate CDs are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Advances from the Federal Home Loan Bank and other borrowings - The fair values of the Corporation's borrowings are estimated using discounted cash flow analysis based on the Corporation's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest - The carrying amounts of accrued interest approximate their fair values.

Floating rate junior subordinated deferrable interest debentures - The fair values of the Corporation's floating rate debentures are estimated using discounted cash flow analysis based on the Corporation's current incremental borrowing rates for similar types of borrowing arrangements.

Off-balance-sheet instruments - Fair values for off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counter parties' credit standings.

Per-Share Data - SFAS No. 128, "Earnings Per Share", requires the dual presentation of basic and diluted earnings per share on the face of the income statement. Basic earnings per share is computed by dividing net income by the weighted-average number of shares outstanding for the period. Diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued. The dilutive effect of options outstanding under Union Financial's stock option plan is reflected in diluted earnings per share by the application of the treasury stock method. Common stock equivalents included in the diluted earnings per share calculation at December 31, 2004 were 69,747 compared to 109,965 at September 30, 2003.

Intangible Assets - Intangible assets consist of core deposit premiums resulting from the Union Financial's branch acquisitions in 1997 and 1999 and the excess of cost over the fair value of net assets resulting from the acquisition of South Carolina Community Bancshares, Inc. in 1999.

Goodwill and identified intangible assets with indefinite lives related to acquisitions are not subject to amortization. Core deposit intangible assets are amortized over their estimated useful lives using methods that reflect the pattern in which the economic benefits are consumed.

The Corporation's unamortized goodwill and other intangible assets are reviewed annually to determine whether there have been any events or circumstances to indicate that the recorded amount is not recoverable from projected undiscounted net operating cash flows. If the projected undiscounted net operating cash flows are less than the carrying amount, a loss is recognized to reduce the carrying amount to fair value, and when appropriate, the amortization period is also reduced.

Interest Income - Interest on loans is accrued and credited to income monthly based on the principal balance outstanding and the contractual rate on the loan. The Corporation places loans on non-accrual status when they become greater than 90 days delinquent or when in the opinion of management, full collection of principal or interest is unlikely. All interest that was accrued prior to the loan being placed on non-accrual status is automatically reversed after the 90 delinquency period. The loans are returned to an accrual status when full collection of principal and interest appears likely.

Risks and Uncertainties - In the normal course of its business, the Corporation encounters two significant types of risk: economic and regulatory. There are three main components of economic risk: interest rate risk, credit risk and market risk. The Corporation is subject to interest rate risk to the degree that its interest-bearing liabilities mature or reprice at different speeds, or on different bases, than its interest-earning assets.

Credit risk is the risk of default on the Corporation's loan portfolio that results from the borrowers' inability or unwillingness to make contractually required payments. Credit risk also applies to investment securities and mortgage-backed securities should the issuer of the security be unable to make principal and interest payments. Market risk reflects changes in the value of collateral underlying loans receivable, the valuation of real estate held by the Corporation and the valuation of investment securities.

1. Summary of Significant Accounting Policies (continued)

The Corporation is subject to the regulations of various government agencies. These regulations can and do change significantly from period to period. The Corporation also undergoes periodic examinations by the regulatory agencies, which may subject it to further changes with respect to asset valuations, amounts of required loss allowances and operating restrictions resulting from the regulators' judgments based on information available to them at the time of their examination.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the dates of the balance sheets and revenues and expenses for the periods covered. Actual results could differ from those estimates and assumptions.

Reclassifications - Certain amounts in prior years' financial statements have been reclassified to conform with current year classifications. These reclassifications had no effect on previously reported net income or shareholders' equity.

Stock-Based Compensation - The Corporation has adopted the disclosure provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). The statement permits the Corporation to continue accounting for stock-based compensation as set forth in Accounting Principles Board ("APB") Opinion 25, Accounting for Stock Issued to Employees, provided the Corporation discloses the pro forma effect on net income and earnings per share of adopting the full provisions of SFAS 123. Accordingly, the Corporation continues to account for stock based compensation under APB Opinion 25 and has provided the required pro forma disclosures.

The Corporation has a stock option plan through which the Board of Directors may grant stock options to officers and employees to purchase common stock of the Corporation at prices not less than 100 % of the fair market value on the date of grant. The outstanding options expire ten years from the date of grant. The Corporation has elected the disclosure-only provision of SFAS No. 123, (Accounting for Stock-Based Compensation). Accordingly, no compensation cost has been charged to operations. Had compensation cost for the plan been determined based on the fair value at the grant dates for awards under the plan consistent with the accounting method available under SFAS No. 123, the Corporation's net income and net income per common share would have been reduced to the pro forma amounts indicated below:

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|---|------------------------------------|---|------------------------------|----------|
| | | | 2003 | 2002 |
| Net income(loss)(in thousands) | | | | |
| As reported | \$ 2,156 | (\$1,210) | \$ 1,859 | \$ 1,744 |
| Deduct: total stock based employee compensation cost determined under fair value based method, net of related tax effects | (77) | (19) | (54) | (46) |
| Pro forma net income(loss) | \$ 2,079 | (\$1,229) | \$ 1,805 | \$ 1,698 |
| Basic net income(loss)per common share | | | | |
| As reported | \$ 1.10 | (\$0.62) | \$ 0.95 | \$ 0.90 |
| Pro forma | \$ 1.06 | (\$0.62) | \$ 0.92 | \$ 0.88 |
| Diluted net income(loss)per common share | | | | |
| As reported | \$ 1.05 | (\$0.62) | \$ 0.90 | \$ 0.86 |
| Pro forma | \$ 1.02 | (\$0.62) | \$ 0.87 | \$ 0.84 |

1. Summary of Significant Accounting Policies (continued)

The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants:

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|--|------------------------------------|--|------------------------------|----------|
| | | | 2003 | 2002 |
| Weighted average fair value of options granted | \$ — | \$ 5.26 | \$ 3.69 | \$ 2.95 |
| Dividend yield | — % | 2% | 4% | 3% |
| Expected volatility | — % | 25% | 25% | 25% |
| Risk-free interest rate | — % | 5% | 5% | 5% |
| Expected lives | — | 10 years | 10 years | 10 years |

2. Investment And Mortgage-backed Securities

Held to Maturity - Securities classified as held to maturity consisted of the following (in thousands):

| | As of December 31, 2004 | | | |
|------------------------|-------------------------|---------------------|--------|---------------|
| | Amortized Cost | Gross Unrealized | | Fair Value |
| | | Gains | Losses | |
| Investment Securities: | | | | |
| Municipal Securities | \$ 1,630 | \$ 58 | \$ — | \$ 1,688 |
| Total held to maturity | \$ 1,630 | \$ 58 | \$ — | \$ 1,688 |

The Corporation had no held to maturity securities at December 31, 2003.

Available for Sale - Securities classified as available for sale consisted of the following (in thousands):

| | As of December 31, 2004 | | | |
|-------------------------------------|-------------------------|---------------------|------------|------------|
| | Amortized Cost | Gross Unrealized | | Fair Value |
| | | Gains | Losses | |
| Investment Securities: | | | | |
| U.S. Agency Obligations | \$ 72,202 | \$ 97 | (\$ 751) | \$ 71,548 |
| Municipal Securities | 19,471 | 1,073 | — | 20,544 |
| Other | 10,964 | 152 | (240) | 10,876 |
| Total Investment Securities | 102,637 | 1,322 | (991) | 102,968 |
| Mortgage-backed Securities: | | | | |
| Fannie Mae | 24,408 | 117 | (313) | 24,212 |
| Ginnie Mae | 99 | 5 | — | 104 |
| Freddie Mac | 7,295 | 95 | (8) | 7,382 |
| Collateralized Mortgage Obligations | 7,257 | — | (59) | 7,198 |
| Total Mortgage-backed Securities | 39,059 | 217 | (380) | 38,896 |
| Total available for sale | \$ 141,696 | \$ 1,539 | (\$ 1,371) | \$ 141,864 |

2. Investment And Mortgage-backed Securities (continued)

| | As of December 31, 2003 | | | |
|---|-------------------------|------------------|-------------------|-------------------|
| | Amortized Cost | Gross Unrealized | | Fair Value |
| | | Gains | Losses | |
| Investment Securities: | | | | |
| U.S. Agency Obligations | \$ 49,891 | \$ — | (\$ 1,151) | \$ 48,740 |
| Municipal Securities | 19,474 | 1,183 | — | 20,657 |
| Other | 7,726 | 60 | — | 7,786 |
| Total Investment Securities | 77,091 | 1,243 | (1,151) | 77,183 |
| Mortgage-backed Securities: | | | | |
| Fannie Mae | 21,403 | — | (44) | 21,359 |
| Ginnie Mae | 1,343 | 72 | — | 1,415 |
| Freddie Mac | 12,711 | 128 | — | 12,839 |
| Collateralized Mortgage Obligations | 11,089 | — | (96) | 10,993 |
| Total Mortgage-backed Securities | 46,546 | 200 | (140) | 46,606 |
| Total available for sale | \$ 123,637 | \$ 1,443 | (\$ 1,291) | \$ 123,789 |

The following table shows gross unrealized losses and fair value, aggregated by investment category, and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2004 (in thousands).

| | Less than 12 Months | | 12 Months or More | | Total | |
|--------------------------------------|---------------------|-------------------|-------------------|-------------------|------------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Securities Available for Sale | | | | | | |
| U.S. Agency Obligations | \$ 21,600 | \$ 140 | \$ 16,399 | \$ 611 | \$ 37,999 | \$ 751 |
| Other | 2,978 | 21 | 3,726 | 219 | 6,704 | 240 |
| Mortgage-backed Securities | 17,578 | 210 | 14,135 | 170 | 31,713 | 380 |
| Total | \$ 42,156 | \$ 371 | \$ 34,260 | \$ 1,000 | \$ 76,417 | \$ 1,371 |

Proceeds, gross gains and gross losses realized from the sales, calls and prepayments of available for sale securities were as follows for the periods ended (in thousands):

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|---|------------------------------------|--|------------------------------|----------------|
| | | | 2003 | 2002 |
| Proceeds | \$ 4,702 | \$ 30,187 | \$ 80,743 | \$ 46,110 |
| Gross gains | \$ 32 | \$ — | \$ 652 | \$ — |
| Gross losses | (8) | (695) | — | (37) |
| Net gain (loss) on investment transactions | \$ 24 | (\$ 695) | \$ 652 | (\$ 37) |

The maturities of available for sale securities at December 31, 2004 are as follows (in thousands):

| | Held to Maturity | Available for Sale |
|--|------------------|--------------------|
|--|------------------|--------------------|

| | <u>Amortized Cost</u> | <u>Fair Value</u> | <u>Amortized Cost</u> | <u>Fair Value</u> |
|---|---------------------------|-----------------------|---------------------------|-----------------------|
| Due in one year or less | \$ — | \$ — | \$ 100 | \$ 103 |
| Due after one year through five years | — | — | 6,564 | 6,599 |
| Due after five years through ten years | — | — | 56,777 | 56,587 |
| Due after ten years | 1,630 | 1,688 | 78,255 | 78,575 |
| | <u>1,630</u> | <u>1,688</u> | <u>141,696</u> | <u>141,864</u> |
| Total investment and mortgage-backed securities | \$ 1,630 | \$ 1,688 | \$ 141,696 | \$ 141,864 |

2. Investment And Mortgage-backed Securities (continued)

The mortgage-backed securities held at December 31, 2004 mature between one and thirty years. The actual lives of those securities may be significantly shorter as a result of principal payments and prepayments.

At December 31, 2004 and 2003, \$62,396,000 and \$63,692,000, respectively, of securities were pledged as collateral for certain deposits and borrowings.

At December 31, 2004, approximately \$16,331,000 of mortgage-backed securities were adjustable rate securities. The adjustment periods range from monthly to annually and rates are adjusted based on the movement of a variety of indices.

Investments in collateralized mortgage obligations ("CMOs") represent securities issued by agencies of the federal government. At December 31, 2004 and December 31, 2003, approximately \$7,198,000 and \$10,993,000 were invested in CMOs.

3. Loans, Net

Loans receivable consisted of the following (in thousands):

| | As of December 31, | |
|---|--------------------|-------------------|
| | 2004 | 2003 |
| Mortgage loans: | | |
| Fixed rate residential | \$ 28,007 | \$ 35,461 |
| Adjustable rate residential | 15,549 | 15,234 |
| Commercial | 43,351 | 40,795 |
| Construction | 3,823 | 2,412 |
| Total mortgage loans | 90,730 | 93,902 |
| Commercial loans: | | |
| Commercial non real estate | 31,168 | 19,949 |
| Commercial lines of credit | 23,628 | 19,853 |
| Total commercial loans | 54,796 | 39,802 |
| Consumer loans: | | |
| Home equity | 14,541 | 11,235 |
| Consumer and installment | 15,879 | 13,885 |
| Consumer lines of credit | 406 | 440 |
| Total consumer loans | 30,826 | 25,560 |
| Total loans | 176,352 | 159,264 |
| Less: | | |
| Undisbursed portion of interim construction loans | (2,363) | (1,105) |
| Loan discount unamortized | (993) | (1,403) |
| Allowance for loan losses | (2,026) | (2,383) |
| Net deferred loan origination costs | 124 | 128 |
| Total, net | \$ 171,094 | \$ 154,501 |
| Weighted-average interest rate of loans | 6.54% | 5.88% |

Under OCC regulations, the Bank may not make loans to one borrower in excess of 15% of unimpaired capital. This limitation does not apply to loans made before August 9, 1989. At December 31, 2004, the Bank had loans outstanding to one borrower ranging up to \$3,200,000.

Servicing loans for others consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors and foreclosure processing. Loan servicing income is recorded on the accrual basis and includes servicing fees received from the investors as well as certain charges collected from the borrowers, such as late payment fees. Loans sold and serviced by the Corporation at December 31, 2004 and 2003 were approximately \$20,654,000 and \$22,467,000, respectively. In connection with these loans serviced for others, the Corporation held borrowers'

escrow balances of \$40,000 at December 31, 2004 and \$59,000 at December 31, 2003.

Adjustable rate residential real estate loans (approximately \$15,549,000 and \$15,234,000 at December 31, 2004 and 2003, respectively) are subject to rate adjustments annually and generally are adjusted based on movement of the Federal Home Loan Bank National Monthly Median Cost of Funds rate or the Constant Maturity Treasury index. The maximum loan rates can be adjusted is 200 basis points in any one year with a lifetime cap of 600 basis points.

3. Loans, Net (continued)

Non refundable deferred origination fees and cost and discount points collected at loan closing, net of commitment fees paid, are deferred and recognized at the time of sale of the mortgage loans. Gain or loss on sales of mortgage loans is recognized based upon the difference between the selling price and the carrying amount of the mortgage loans sold. Other fees earned during the loan origination process are also included in net gain or loss on sales of mortgage loans.

Until 2002, the Bank originated both fixed rate and adjustable rate mortgage loans with terms generally ranging from 15 to 30 years and generally sold the loans while retaining servicing on loans originated. The Bank discontinued the origination of loans held for sale in 2002. The underlying value of loans serviced were \$20,654,000 and \$22,467,000 at December 31, 2004 and 2003, respectively.

At December 31, 2004 and 2003, loans which are accounted for on a non-accrual basis or contractually past due ninety days or more totaled approximately \$750,000 and \$2,829,000, respectively. The amount the Corporation will ultimately realize from these loans could differ materially from their carrying value because of future developments affecting the underlying collateral or the borrower's ability to repay the loans. During the year ended December 31, 2004, the three months ended December 31, 2003 and the years ended September 30, 2003 and 2002, the Corporation recognized no interest income on loans past due 90 days or more, whereas, under the original terms of these loans, the Corporation would have recognized additional interest income of approximately \$44,800, \$32,393, \$160,600, and \$111,500, respectively.

The changes in the allowance for loan losses consisted of the following (in thousands):

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|--------------------------------|------------------------------------|--|------------------------------|----------|
| | | | 2003 | 2002 |
| Balance at beginning of period | \$ 2,383 | \$ 1,842 | \$ 1,371 | \$ 1,080 |
| Provision for loan losses | 1,250 | 725 | 725 | 990 |
| (Charge-offs) recoveries, net | (1,607) | (184) | (254) | (699) |
| Balance at end of period | \$ 2,026 | \$ 2,383 | \$ 1,842 | \$ 1,371 |

Directors and officers of the Corporation are customers of the Corporation in the ordinary course of business. Loans of directors and officers have terms consistent with those offered to other customers. Loans to officers and directors of the Corporation are summarized as follows (in thousands):

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|------------------------------------|------------------------------------|--|------------------------------|----------|
| | | | 2003 | 2002 |
| Balance at beginning of period | \$ 644 | \$ 704 | \$ 1,301 | \$ 1,132 |
| Loans originated during the period | 250 | 1 | 38 | 404 |
| Loan repayments during the period | (203) | (61) | (635) | (235) |
| Balance at end of period | \$ 691 | \$ 644 | \$ 704 | \$ 1,301 |

4. Office Properties And Equipment

Office properties and equipment consisted of the following (in thousands):

| | As of December 31, | |
|--|--------------------|---------|
| | 2004 | 2003 |
| Land | \$ 766 | \$ 766 |
| Building and improvements | 5,015 | 4,994 |
| Office furniture, fixtures and equipment | 5,113 | 4,978 |
| Total | 10,894 | 10,738 |
| Less accumulated depreciation | (5,259) | (4,323) |

| |
|--------------------------------------|
| Office properties and equipment, net |
|--------------------------------------|

| |
|----------|
| \$ 5,635 |
|----------|

| |
|----------|
| \$ 6,415 |
|----------|

Depreciation expense was \$979,000, \$264,000, \$1,048,000, and \$895,000 for the year ended December 31, 2004, the three months ended December 31, 2003 and the years ended September 30, 2003, and 2002.

5. Intangible Assets

The changes in intangible assets consisted of the following (in thousands):

| | Year Ended | Three | Year Ended | |
|---|----------------------|---|------------|----------|
| | December 31, 2004 | Months Ended December 31, 2003 | 2003 | 2002 |
| Intangible balance at beginning of year | \$ 3,320 | \$ 3,479 | \$ 4,115 | \$ 4,771 |
| Amortization/other | (636) | (159) | (636) | (656) |
| Intangible balance at end of year | \$ 2,684 | \$ 3,320 | \$ 3,479 | \$ 4,115 |
| Goodwill intangible | \$ 1,528 | \$ 1,528 | \$ 1,528 | \$ 1,528 |

6. Deposit Accounts

Deposit accounts at December 31, were as follows (in thousands):

| Account Type | 2004 | | | 2003 | | |
|--|--------------|-------------------|----------------|--------------|-------------------|----------------|
| | Rate | Balance | % | Rate | Balance | % |
| NOW accounts: | | | | | | |
| Commercial non interest-bearing | | \$ 13,574 | 5.96% | | \$ 9,905 | 4.44% |
| Noncommercial | 0.33% | 22,146 | 9.73% | 1.45% | 22,036 | 9.88% |
| Money market checking accounts | 1.81% | 26,603 | 11.69% | 1.05% | 13,308 | 5.96% |
| Regular savings | 0.41% | 17,808 | 7.83% | 0.70% | 16,866 | 7.56% |
| Total demand and savings deposits | 0.71% | 80,131 | 35.21% | 1.01% | 62,115 | 27.84% |
| Savings certificates: | | | | | | |
| Up to 3.00% | | 102,454 | 45.02% | | 111,071 | 49.78% |
| 3.01 % - 4.00% | | 24,522 | 10.77% | | 16,645 | 7.46% |
| 4.01 % - 5.00% | | 12,934 | 5.68% | | 16,730 | 7.49% |
| 5.01 % - 6.00% | | 3,155 | 1.39% | | 5,468 | 2.45% |
| 6.01 % - 7.00% | | 307 | 0.14% | | 505 | 0.23% |
| 7.01 % - 8.00% | | 188 | 0.08% | | 182 | 0.08% |
| Total savings certificates | 2.32% | 143,560 | 63.08% | 2.80% | 150,601 | 67.49% |
| Sweep accounts | 1.23% | 3,898 | 1.71% | 0.95% | 10,415 | 4.67% |
| Total deposit accounts | 1.87% | \$ 227,589 | 100.00% | 2.17% | \$ 223,131 | 100.00% |

As of December 31, 2004 and 2003, total deposit accounts include approximately \$1,737,000 and \$1,960,000, respectively, of deposits from the Corporation's officers, directors, employees or parties related to them.

At December 31, 2004 and 2003, deposit accounts with balances of \$100,000 and over totaled approximately \$51,655,000 and \$57,763,000, respectively.

Savings certificates by maturity were as follows (in thousands):

| As of December 31, | |
|--------------------|------|
| 2004 | 2003 |

Maturity Date

| | | |
|----------------------------|------------|------------|
| Within 1 year | \$ 92,334 | \$ 101,688 |
| After 1 but within 2 years | 42,036 | 32,043 |
| After 2 but within 3 years | 6,508 | 12,020 |
| After 3 but within 4 years | 1,733 | 2,822 |
| Thereafter | 949 | 2,028 |
| | <hr/> | <hr/> |
| Total savings certificates | \$ 143,560 | \$ 150,601 |
| | <hr/> | <hr/> |

6. Deposit Accounts (continued)

Interest expense on deposits consisted of the following (in thousands):

| Account Type | Year Ended | Three | Years Ended | |
|--|----------------------|---|-----------------|-----------------|
| | December 31, 2004 | Months Ended December 31, 2003 | 2003 | 2002 |
| NOW accounts and money market deposit accounts | \$ 435 | \$ 71 | \$ 277 | \$ 426 |
| Passbook and statement savings accounts | 72 | 26 | 116 | 146 |
| Certificate accounts | 3,410 | 939 | 4,281 | 5,453 |
| Early withdrawal penalties | (14) | (5) | (14) | (24) |
| Total | \$ 3,903 | \$ 1,031 | \$ 4,660 | \$ 6,001 |

7. Advances From The Federal Home Loan Bank And Other Borrowings

At December 31, 2004 and 2003, the Bank had \$63,500,000 and \$68,500,000, respectively, of advances outstanding from the FHLB. The maturity of the advances from the FHLB is as follows (in thousands):

| | As of December 31, | | | |
|---|--------------------|--------------|------------------|--------------|
| | 2004 | Wtd Avg Rt | 2003 | Wtd Avg Rt |
| Contractual Maturity: | | | | |
| Within one year - fixed rate | \$ 5,000 | 2.96% | \$ 5,000 | 4.14% |
| Within one year - adjustable rate | — | — | 8,000 | 1.17% |
| After one but within three years - fixed rate | 13,000 | 2.58% | 10,000 | 2.80% |
| After three but within five years - adjustable rate | 23,500 | 3.04% | 16,000 | 1.98% |
| Greater than five years - adjustable rate | 22,000 | 4.44% | 29,500 | 4.66% |
| Total Advances | \$ 63,500 | 3.42% | \$ 68,500 | 3.32% |

The Bank pledges as collateral to the advances their FHLB Stock, and has entered into a blanket collateral agreement with the FHLB whereby the Bank maintains, free of other encumbrances, qualifying mortgages (as defined) with unpaid principal balances equal to, when discounted at 50% to 80% of the unpaid principal balances, 100% of total advances. The amount of qualifying loans was \$37,934,000 and \$54,564,000, respectively, at December 31, 2004 and 2003.

8. Securities Sold Under Agreements to Repurchase

The Company had \$24,000,000 and \$5,000,000 borrowed under agreements to repurchase at December 31, 2004 and 2003, respectively. The amortized cost of the securities underlying the agreements to repurchase at December 31, 2004 was \$28,016,000 and \$7,103,000 at December 31, 2003. The maximum amount outstanding at any month end during 2004 was \$29,000,000 and \$17,000,000 for 2003. The average amount of outstanding agreements for 2004 was \$21,333,000 and \$14,500,000 for 2003 and the approximate weighted average interest rate was 2.82% in 2004 and 4.67% in 2003.

9. Floating Rate Junior Subordinated Deferrable Interest Debentures

On November 14, 2001, the Corporation sponsored the creation of the Trust. The Corporation is the owner of all of the common securities of the Trust. On December 18, 2001, the Trust issued \$8,000,000 in the form of floating rate capital securities through a pooled trust preferred securities offering. The proceeds from this issuance, along with the Corporation's \$248,000 capital contribution for the Trust's common securities, were used to acquire \$8,247,000 aggregate principal amount of the Corporation's floating rate junior subordinated deferrable interest debentures due December 18, 2031 (the "Debentures"), which constitute the sole asset of the Trust. The interest rate on the Debentures and the capital securities is variable and adjustable quarterly at 3.60% over the three-month LIBOR, with an initial rate of 5.60%. A rate cap of 12.50% is effective through December 18, 2006. The Corporation has, through the Trust agreement establishing the Trust, the Guarantee Agreement, the notes and the related Debenture, taken together, fully irrevocably and unconditionally guaranteed all of the Trust's obligations under the capital securities.

The stated maturity of the Debentures is December 18, 2031. In addition, the Debentures are subject to redemption at par at the option of the

Corporation, subject to prior regulatory approval, in whole or in part on any interest payment date after December 18, 2006. The Debentures are also subject to redemption prior to December 18, 2006 at 107.5% of par after the occurrence of certain events that would either have a negative tax effect on the Trust or the Corporation or would result in the Trust being treated as an investment company that is required to be registered under the Investment Company Act of 1940. Upon repayment of the Debentures at their stated maturity or following their redemption, the Trust will use the proceeds of such repayment to redeem an equivalent amount of outstanding trust preferred securities and trust common securities.

9. Floating Rate Junior Subordinated Deferrable Interest Debentures (continued)

The Corporation has the right, at one or more times, to defer interest payments on the Debentures for up to twenty consecutive quarterly periods. All deferrals will end on an interest payment date and will not extend beyond December 18, 2031, the stated maturity date of the Debentures. If the Corporation defers interest payments on the Debentures, the Trust will also defer distributions on the capital securities. During any deferral period, each installment of interest that would otherwise have been due and payable will bear additional interest at the applicable distribution rate, compounded quarterly. The Corporation paid \$426,000, \$100,000, \$415,000 and \$365,000 in interest for the year ended December 31, 2004, the three months ended December 31, 2003, and the years ended September 30, 2003 and 2002.

10. Income Taxes

Income tax expense (benefit) is summarized as follows (in thousands):

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2004 | Years Ended September 30, | |
|--|------------------------------------|--|------------------------------|---------------|
| | | | 2003 | 2002 |
| Current | \$ 225 | (\$127) | \$ 912 | \$ 747 |
| Deferred | 496 | (515) | (341) | (189) |
| Total income tax expense(benefit) | \$ 721 | (\$642) | \$ 571 | \$ 558 |

The provision (benefit) for income taxes differed from amounts computed by applying the statutory federal rate of 34% to income before income taxes as follows (in thousands):

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2004 | Years Ended September 30, | |
|--|------------------------------------|--|------------------------------|---------------|
| | | | 2003 | 2002 |
| Tax at federal income tax rate | \$ 978 | (\$ 584) | \$ 826 | \$ 783 |
| Increase (decrease) resulting from: | | | | |
| State income taxes, net of federal benefit | 81 | — | 110 | 54 |
| Interest on municipal bonds | (327) | (85) | (300) | (232) |
| Non-taxable life insurance income | (62) | — | (84) | (88) |
| Other, net | 51 | 27 | 19 | 41 |
| Total | \$ 721 | (\$ 642) | \$ 571 | \$ 558 |

The tax effects of significant items comprising the Corporation's deferred taxes as of December 31, 2004 and 2003 are as follows (in thousands):

| | December 31, | |
|---|--------------|--------------|
| | 2004 | 2003 |
| Deferred tax assets: | | |
| Book reserves in excess of tax basis bad debt reserves arising after September 30, 1988 | \$ 689 | \$ 962 |
| Difference between book and deposit premium basis | 117 | (28) |
| Deferred Compensation | 154 | 129 |
| Net operating loss | — | 479 |
| Other | 57 | 82 |
| Total deferred tax asset | 1,017 | 1,624 |
| Deferred tax liabilities: | | |
| SFAS No. 115 mark to market adjustment | 59 | 53 |
| Difference between book and tax property basis | 264 | 283 |
| Difference between book and tax Federal Home Loan Bank stock basis | 85 | 100 |

| | | |
|---|-------------------|-------------------|
| Deferred loan fees | 42 | 51 |
| Tax mark to market adjustment on securities | — | 27 |
| Other | — | 41 |
| | <u> </u> | <u> </u> |
| Total deferred tax liability | 450 | 555 |
| | <u> </u> | <u> </u> |
| Net deferred tax asset | \$ 567 | \$ 1,069 |
| | <u> </u> | <u> </u> |

10. Income Taxes (continued)

The deferred tax assets of \$567,000 and \$1,069,000 at December 31, 2004 and 2003 are included in other assets in the balance sheet. A deferred tax asset of \$893,000 at September 30, 2003 is included in other assets in the balance sheet.

Retained earnings at December 31, 2004 includes approximately \$1,636,000 representing pre-1988 tax bad debt base year reserve amounts for which no deferred income tax liability has been provided since these reserves are not expected to reverse until indefinite future periods and may never reverse. Circumstances that would require an accrual of a portion or all of this unrecorded tax liability are a reduction in qualifying loan levels relative to the end of 1987, dividend payments in excess of current year or accumulated tax earnings and profits, or other distributions in dissolutions, liquidations or redemption of the Bank's stock.

The Corporation has been permitted under the Internal Revenue Code to deduct an annual addition to the tax reserve for bad debts in determining taxable income, subject to certain limitations. This addition may differ significantly from the bad debt expense for financial reporting purposes and was based on either 8% of taxable income (the "Percentage of Taxable Income") or actual loan loss experience (the "Experience Method") for the years prior to 1997. As a result of recent tax legislation, the Corporation will be required to recapture tax bad debt reserves in excess of pre-1988 based year amounts over a period of approximately six to eight years.

11. Employee Benefits

The Corporation has a contributory profit-sharing plan which is available to all eligible employees. Annual employer contributions to the plan consist of an amount which matches participant contributions up to a maximum of 5% of a participant's compensation and a discretionary amount determined annually by the Corporation's Board of Directors. The annual contributions to the pension plan will be 5% of a participant's compensation. Employer expensed contributions to the plans were \$240,000, \$31,000, \$183,000, and \$187,000 for the year ended December 31, 2004, for the three months ended December 31, 2003, and the years ended September 30, 2003 and 2002.

12. Financial Instruments

The Corporation is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments are commitments to extend credit. They involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheets. The contract or notional amounts of those instruments reflect the extent of involvements the Corporation has in particular classes of financial instruments.

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as they do for on-balance-sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral held varies but may include accounts receivable, inventory, property, plant, and equipment and income-producing commercial properties.

The Corporation had loan commitments as follows (in thousands):

| | As of December 31, | |
|--|--------------------|------------------|
| | 2004 | 2003 |
| Fixed/variable interest rate commitments to fund residential credit | \$ 2,399 | \$ 3,640 |
| Commitments to fund commercial and construction loans | 2,363 | 1,105 |
| Unused portion of credit lines (principally variable-rate consumer lines secured by real estate) | 35,842 | 23,247 |
| Total | \$ 40,604 | \$ 27,992 |

The Corporation has no additional financial instruments with off-balance sheet risk.

The Corporation did not incurred any losses on its commitments in fiscal 2004, the three months ended December 31, 2003, fiscal 2003 or 2002.

12. Financial Instruments (continued)

The estimated fair values of the Corporation's financial instruments were as follows at December 31, 2004 (in thousands):

| | December 31, 2004 | |
|--|-------------------|------------|
| | Carrying Amount | Fair Value |
| <u>Financial assets</u> | | |
| Cash and cash equivalents | \$ 13,197 | \$ 13,197 |
| Securities available for sale | 141,864 | 141,864 |
| Securities held to maturity | 1,630 | 1,688 |
| Federal Home Loan Bank Stock, at cost | 3,522 | 3,522 |
| Federal Reserve Stock, at cost | 539 | 539 |
| Loans, net | 171,094 | 171,632 |
| Accrued interest receivable | 2,068 | 2,068 |
| Cash surrender value of life insurance | 5,206 | 5,206 |
| <u>Financial liabilities</u> | | |
| Deposits | \$ 227,589 | \$ 228,415 |
| Advances from FHLB and other borrowings | 63,500 | 64,122 |
| Securities sold under agreement to repurchase | 24,000 | 24,235 |
| Floating rate junior subordinated deferrable interest debentures | 8,247 | 8,328 |
| Accrued interest payable | 333 | 333 |
| <u>Off-balance-sheet assets (liabilities)</u> | | |
| Commitments to extend credit | (\$40,604) | (\$40,604) |

The estimated fair values of the Corporation's financial instruments were as follows at December 31, 2003 (in thousands):

| | December 31, 2003 | |
|--|-------------------|------------|
| | Carrying Amount | Fair Value |
| <u>Financial assets</u> | | |
| Cash and cash equivalents | \$ 28,702 | \$ 28,702 |
| Securities available for sale | 123,789 | 123,789 |
| Federal Home Loan Bank Stock, at cost | 3,900 | 3,900 |
| Federal Reserve Stock, at cost | 539 | 539 |
| Loans | 154,501 | 155,690 |
| Accrued interest receivable | 1,655 | 1,655 |
| Cash surrender value of life insurance | 5,025 | 5,025 |
| <u>Financial liabilities</u> | | |
| Deposits | \$ 223,131 | \$ 219,315 |
| Advances from FHLB and other borrowings | 68,500 | 66,273 |
| Securities sold under agreement to repurchase | 5,000 | 5,000 |
| Floating rate junior subordinated deferrable interest debentures | 8,000 | 7,997 |
| Accrued interest payable | 285 | 285 |
| <u>Off-balance-sheet asset (liabilities)</u> | | |
| Commitments to extend credit | (\$27,992) | (\$27,992) |

13. Supplemental Cash Flow Disclosures

| | Year Ended | Three | Years Ended | |
|---|----------------------|---|---------------|----------|
| | December 31, 2004 | Months Ended December 31, 2003 | September 30, | |
| | | | 2003 | 2002 |
| Cash paid for: | | | | |
| Income taxes | \$ 120 | \$ 59 | \$ 488 | \$ 2,593 |
| Interest | 7,198 | 2,384 | 8,702 | 9,775 |
| Non-cash transactions: | | | | |
| Loans foreclosed | 757 | 295 | 296 | 366 |
| Unrealized gain (loss) on securities available for sale | \$ 227 | \$ 152 | (\$ 853) | \$ 2,179 |

14. Commitments And Contingencies

Lease commitments - The Corporation leases certain Bank facilities under rental agreements that expires in 2018. Future minimum rental payments due under these leases are as follows:

| Years Ended | |
|-------------|--------------|
| 2005 | 163,344 |
| 2006 | 163,344 |
| 2007 | 163,344 |
| 2008 | 163,344 |
| 2009 | 163,344 |
| Thereafter | \$ 1,388,424 |

Total rent expense for the year ended December 31, 2004, for the three months ended December 31, 2003, and the years ended September 30, 2003 and 2002 were \$186,000, \$41,000, \$34,000 and \$0, respectively.

Concentrations of Credit Risk - The Corporation's business activity is principally with customers located in South Carolina. Except for residential loans in the Corporation's market area, the Corporation has no other significant concentrations of credit risk.

Litigation - The Corporation is involved in legal actions in the normal course of business. In the opinion of management, based on the advice of its general counsel, the resolution of these matters will not have a material adverse impact on future results of operations or the financial position of the Corporation.

Potential Impact of Changes in Interest Rates - The Corporation's profitability depends to a large extent on its net interest income, which is the difference between interest income from loans and investments and interest expense on deposits and borrowings. Like most financial institutions, the Corporation's interest income and interest expense are significantly affected by changes in market interest rates and other economic factors beyond its control. Management seeks to manage the relationships between interest-sensitive assets and liabilities in order to protect against wide interest rate fluctuations. See "Asset and Liability Management".

15. Stock Option Plans

A summary of the status of the plans as of December 31, 2004 and 2003, and changes during the years ending on the dates presented below (all shares have been adjusted for the 3:2 stock split in February 1998 and the 5% stock dividend in February 1999):

| Grant Date | Shares Granted | Average Exercise Price Per Share | Expiration Date | Earliest Date Exercisable |
|---------------|-------------------|---|-----------------|------------------------------|
| October, 1995 | 50,504 | 5.79 | October, 2005 | October, 1995 |
| January, 1996 | 945 | 5.79 | January, 2006 | January, 1996 |
| April, 1996 | 1,725 | 6.67 | April, 2006 | April, 1997 |
| May, 1998 | 24,570 | 15.83 | May, 2008 | May, 1998 |
| October, 2000 | 5,300 | 8.75 | October, 2010 | October, 2000 |
| January, 2001 | 27,365 | 9.06 | January, 2011 | January, 2001 |
| January, 2002 | 22,887 | 10.36 | January, 2012 | January, 2002 |
| April, 2002 | 5,000 | 13.00 | April, 2012 | April, 2002 |

| | | | | |
|----------------|--------|-------|----------------|----------------|
| November, 2002 | 1,500 | 13.25 | November, 2012 | November, 2002 |
| December, 2003 | 43,000 | 16.75 | December, 2013 | December, 2003 |

| | |
|----------------------|----------------|
| Total Shares Granted | <u>182,796</u> |
|----------------------|----------------|

15. Stock Option Plans (continued)

At December 31, 2004, the Corporation had the following options exercisable:

| Fiscal Year | Range of exercise price | Weighted Average Remaining Contractual Life | Number Options Exercisable | Average Exercise Price |
|--------------------|--------------------------------|--|-----------------------------------|-------------------------------|
| 1995 | \$ 5.79 | 1 years | 50,504 | \$ 5.79 |
| 1996 | \$ 5.79 - \$6.67 | 2.3 years | 2,670 | 6.36 |
| 1998 | \$ 15.83 | 5.3 years | 24,574 | 15.83 |
| 2000 | \$ 8.75 | 5.8 years | 5,300 | 8.75 |
| 2001 | \$ 9.06 | 7 years | 27,365 | 9.06 |
| 2002 | \$ 10.36-\$13.25 | 7.6 years | 29,103 | 10.96 |
| 2003 | \$ 16.75 | 9 years | 17,200 | 16.75 |
| | \$ 5.79 -\$16.75 | 5.4 years | 156,716 | \$ 10.20 |

Options for the three previous fiscal years were exercised as follows (adjusted for stock splits and dividends):

| For the Years Ended | Shares Exercised | Average Exercise Price Per Share |
|----------------------------|-------------------------|---|
| December 31, 2004 | 60,635 | \$ 6.18 |
| September 30, 2003 | 19,994 | \$ 8.95 |
| September 30, 2002 | 23,605 | \$ 5.97 |

Stock options for 500 shares at an average price of \$9.06 were forfeited during the year ended December 31, 2004. Stock options for 6,087 shares at an average price of \$11.54 were forfeited during the year ended September 30, 2003. Stock options for 14,023 shares at an average price of \$11.75 were forfeited during the year ended September 30, 2002. At December 31, 2004, 33,623 shares were available for grant and 156,716 options at an average price of \$8.35 were outstanding.

16. Liquidation Account, Dividend Restrictions And Regulatory Matters

On August 7, 1987, the Bank completed its conversion from a federally chartered mutual association to a federally chartered stock association. A special liquidation account was established by the Bank for the pre-conversion retained earnings of approximately \$3,718,000. The liquidation account is maintained for the benefit of depositors who held a savings or demand account as of the March 31, 1986 eligibility or the June 30, 1987 supplemental eligibility record dates who continue to maintain their deposits at the Bank after the conversion. In the event of a future liquidation (and only in such an event), each eligible and supplemental eligible account holder who continues to maintain his or her savings account will be entitled to receive a distribution from the liquidation account. The total amount of the liquidation account will be decreased in an amount proportionately corresponding to decreases in the savings account balances of eligible and supplemental eligible account holders on each subsequent annual determination date. Except for payment of dividends by the Bank to Union Financial and repurchase of the Bank's stock, the existence of the liquidation account will not restrict the use or application of such net worth.

The Bank is prohibited from declaring cash dividends on its common stock or repurchasing its common stock if the effect thereof would cause its net worth to be reduced below either the amount required for the liquidation account or the minimum regulatory capital requirement. In addition, the Bank is also prohibited from declaring cash dividends and repurchasing its own stock without prior regulatory approval if the total amount of all dividends and stock repurchases (including any proposed dividends and stock repurchases) for the applicable calendar year exceeds its current year's net income plus its retained net income for the preceding two years. Under current OCC regulations the Bank is limited in the amount it may loan to affiliates, including the Corporation. Loans to a single affiliate may not exceed 10%, and the aggregate of loans to all affiliates may not exceed 20% of bank capital and surplus.

The Bank and the Corporation are subject to various regulatory capital requirements administered by banking regulators. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporations' financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action. The Bank must meet specific capital guidelines that involve quantitative measures of the bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Banks capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulations to ensure capital adequacy require the Bank and the Corporation to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets (as defined in the regulations). Management believes,

as of December 31, 2004, that the Bank and the Corporation meet the capital adequacy requirements to which they are subject.

As of December 31, 2004 and 2003, the Bank was “well capitalized” under the regulatory framework for prompt corrective action based on its capital ratio calculations. In order to be “well capitalized”, the bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since December 31, 2004 that management believes have changed the bank’s classification.

Under present regulations of the Office of the Comptroller of the Currency (“OCC”), the Bank must have core capital (leverage requirement) equal to 4.0% of assets, of which 1.5% must be tangible capital, excluding intangible assets. The Bank must also maintain risk-based regulatory capital as a percent of risk weighted assets at least equal to 8.0%. In measuring compliance with capital standards, certain adjustments must be made to capital and total assets.

16. Liquidation Account, Dividend Restrictions And Regulatory Matters (continued)

The following tables present the total risk-based, Tier 1 risk-based and Tier 1 leverage requirements for the Corporation and the Bank (in thousands).

| | December 31, 2004 | | | | | |
|---------------------------------------|-------------------|--------------|-------------------|---------------|--------------|--------------------|
| | Amount | Actual Ratio | Regulatory Amount | Minimum Ratio | “Well Amount | Capitalized” Ratio |
| Leverage ratio | | | | | | |
| Corporation | \$ 29,510 | 8.42% | \$ 14,012 | 4% | n/a | n/a |
| Bank | 28,958 | 8.27% | 14,012 | 4% | \$ 17,516 | 5% |
| Tier 1 capital ratio | | | | | | |
| Corporation | 29,510 | 14.61% | 8,078 | 4% | n/a | n/a |
| Bank | 28,958 | 14.33% | 8,083 | 4% | 12,124 | 6% |
| Total risk-based capital ratio | | | | | | |
| Corporation | 31,536 | 15.62% | 16,156 | 8% | n/a | n/a |
| Bank | 30,984 | 15.33% | 16,165 | 8% | 20,207 | 10% |

| | December 31, 2003 | | | | | |
|---------------------------------------|-------------------|--------------|-------------------|---------------|--------------|--------------------|
| | Amount | Actual Ratio | Regulatory Amount | Minimum Ratio | “Well Amount | Capitalized” Ratio |
| Leverage ratio | | | | | | |
| Corporation | \$ 28,518 | 8.40% | \$ 13,584 | 4% | n/a | n/a |
| Bank | 27,753 | 8.17% | 13,584 | 4% | \$ 16,980 | 5% |
| Tier 1 capital ratio | | | | | | |
| Corporation | 28,518 | 16.18% | 7,048 | 4% | n/a | n/a |
| Bank | 27,753 | 15.74% | 7,051 | 4% | 10,576 | 6% |
| Total risk-based capital ratio | | | | | | |
| Corporation | 30,723 | 17.44% | 14,097 | 8% | n/a | n/a |
| Bank | 29,958 | 17.00% | 14,102 | 8% | 17,627 | 10% |

Under current Federal Reserve guidelines, the Corporation includes trust preferred securities in Tier 1 capital. As noted in “Recent Accounting Pronouncements” in the Summary of Significant Accounting Policies section, FASB Interpretation No. 46 the Corporation is required to deconsolidate its investment in its subsidiary trusts.

The Bank is required to maintain reserves, in the form of cash and balances with the Federal Reserve Bank, against its deposit liabilities. The amounts of such reserves totaled \$858,000 at December 31, 2004 and \$807,000 at December 31, 2003.

17. Recently Issued Accounting Standards

The following is a summary of recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by the Corporation:

In December 2004, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 123 (revised 2004), “Share-Based Payment” (“SFAS No. 123(R)”). SFAS No. 123(R) will require companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its financial statements. In addition, the adoption of SFAS No. 123(R) requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. SFAS No. 123(R) is effective beginning as of the first interim or annual reporting period beginning after December 15, 2005. The Corporation is currently evaluating the impact that the adoption of SFAS No. 123(R) will have on its financial position, results of operations and cash flows. The cumulative effect of adoption, if any, will be measured and recognized in the statement of income on the date of adoption.

In November 2002, the FASB issued FASB Interpretation (“FIN”) No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.” FIN No. 45 elaborates on the disclosure to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees and warranties that it has issued. FIN 45 requires a company, at the time it issues a guarantee, to recognize an initial liability for the fair value of obligations assumed under the guarantee. The initial recognition requirements of FIN No. 45 were effective for guarantees issued or modified after December 31, 2002. The disclosure requirements were effective for financial statements for periods ending after December 15, 2002. The adoption of FIN No. 45 did not have a material impact on the Corporation’s financial position or results of operations.

In December 2003, the FASB issued FIN No. 46 (revised), “Consolidation of Variable Interest Entities” (“FIN No. 46(R)”), which addresses

consolidation by business enterprises of variable interest entities. FIN No. 46(R) requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns, or both. FIN No. 46(R) also requires disclosures about variable interest entities that a company is not required to consolidate, but in which it has a significant variable interest. FIN No. 46(R) provides guidance for determining whether an entity qualifies as a variable interest entity by considering, among other considerations, whether the entity lacks sufficient equity or its equity.

17. Recently Issued Accounting Standards (continued)

holders lack adequate decision-making ability. The consolidation requirements of FIN No. 46(R) applied immediately to variable interest entities created after January 31, 2003. The consolidation requirements applied to the Corporation's existing variable interest entities in the first reporting period ending after December 15, 2004. Certain of the disclosure requirements applied to all financial statements issued after December 31, 2003, regardless of when the variable interest entity was established. In accordance with these rules, the Corporation deconsolidated the Trust as of December 31, 2004, which was formed to raise capital by issuing trust preferred securities. The full and unconditional guarantee by the Corporation for the trust preferred securities remains in effect.

In November 2003, the Emerging Issues Task Force ("EITF") reached a consensus that certain quantitative and qualitative disclosures should be required for debt and marketable equity securities classified as available for sale or held to maturity under SFAS No. 115 and SFAS No. 124 that are impaired at the balance sheet date but for which other-than-temporary impairment has not been recognized. Accordingly the EITF issued EITF No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." This issue addresses the meaning of other-than-temporary impairment and its application to investments classified as either available for sale or held to maturity under SFAS No. 115 and provides guidance on quantitative and qualitative disclosures. The disclosure requirements of EITF No. 03-1 are effective for annual financial statements for fiscal years ending after June 15, 2004. The effective date for the measurement and recognition guidance of EITF No. 03-1 has been delayed. The FASB staff has issued a proposed Board-directed FASB Staff Position ("FSP"), FSP EITF 03-1-a, "Implementation Guidance for the Application of Paragraph 16 of Issue No. 03-1." The proposed FSP would provide implementation guidance with respect to debt securities that are impaired solely due to interest rates and/or sector spreads and analyzed for other-than-temporary impairment under the measurement and recognition requirements of EITF No. 03-1. The delay of the effective date for the measurement and recognition requirements of EITF No. 03-1 will be superseded concurrent with the final issuance of FSP EITF 03-1-a. Adopting the disclosure provisions of EITF No. 03-1 did not have any impact on the Corporation's financial position or results of operations.

In March 2004, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 105, "Application of Accounting Principles to Loan commitments," to inform registrants of the Staff's view that the fair value of the recorded loan commitments should not consider the expected future cash flows related to the associated servicing of the future loan. The provisions of SAB No. 105 must be applied to loan commitments accounted for as derivatives that are entered into after March 31, 2004. The Staff will not object to the application of existing accounting practices to loan commitments accounted for as derivatives that are entered into on or before March 31, 2004, with appropriate disclosures. The Corporation adopted the provisions of SAB No. 105 on April 1, 2004. The adoption of SAB No. 105 did not have a material impact on the Corporation's financial condition or results of operations.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

**18. Union Financial Bancshares, Inc. Financial Information
(Parent Corporation Only)**

Condensed financial information for Union Financial is presented as follows (in thousands):

| Condensed Balance Sheets | As of December 31, | |
|--|---------------------------|------------------|
| | 2004 | 2003 |
| Assets: | | |
| Cash and cash equivalents | \$ 468 | \$ 624 |
| Investment in subsidiary | 33,467 | 32,743 |
| Other | 351 | 403 |
| Total Assets | \$ 34,286 | \$ 33,770 |
| Liabilities and Shareholders' Equity: | | |
| Accrued interest payable | \$ 20 | \$ 16 |
| Floating rate junior subordinated deferrable interest debentures | 8,247 | 8,247 |
| Shareholders' Equity | 26,019 | 25,507 |
| Total Liabilities and Shareholders' Equity | \$ 34,286 | \$ 33,770 |

18. Union Financial Bancshares, Inc. Financial Information (continued)
(Parent Corporation Only)

| | Year Ended December 31, 2004 | Three Months Ended December 31, 2003 | Years Ended September 30, | |
|--|------------------------------------|---|------------------------------|----------|
| | | | 2003 | 2002 |
| Condensed Statements of Income | | | | |
| Equity in undistributed earnings(loss)of subsidiary | \$ 2,714 | (\$1,077) | \$ 2,399 | \$ 2,210 |
| Interest expense | (426) | (100) | (415) | (365) |
| Other expense, net | (132) | (33) | (125) | (101) |
| Net income(loss) | \$ 2,156 | (\$ 1,210) | \$ 1,859 | \$ 1,744 |
| Condensed Statements of Cash Flows | | | | |
| Operating Activities: | | | | |
| Net income(loss) | \$ 2,156 | (\$1,210) | \$ 1,859 | \$ 1,744 |
| Adjustments to reconcile net income(loss) to net cash used in operating activities: | | | | |
| Equity in undistributed earnings(loss) of subsidiary | (2,714) | 1,077 | (2,399) | (2,210) |
| (Increase) decrease in other assets | 56 | 26 | 54 | (134) |
| Net cash used in operating activities | (502) | (107) | (486) | (600) |
| Financing Activities: | | | | |
| Proceeds from issuance of floating rate junior subordinated deferrable interest debentures | — | — | — | 8,000 |
| Capital contribution to subsidiary | — | — | — | (5,000) |
| Dividends received from subsidiary | 2,000 | — | — | — |
| Dividend reinvestment plan contributions | 110 | 27 | 110 | 111 |
| Dividends paid | (783) | (197) | (788) | (777) |
| Share repurchase program | (1,074) | — | (366) | — |
| Proceeds from the exercise of stock options | 93 | 17 | 179 | 141 |
| Net cash provided by (used in) financing activities | 346 | (153) | (865) | 2,475 |
| Net increase (decrease) in cash and cash equivalents | (156) | (260) | (1,351) | 1,875 |
| Cash and cash equivalents at beginning of period | 624 | 884 | 2,235 | 360 |
| Cash and cash equivalents at end of period | \$ 468 | \$ 624 | \$ 884 | \$ 2,235 |

**Board of Directors
Union Financial Bancshares And Subsidiaries**

Robert H. Breakfield

Attorney

James W. Edwards

Dean of Academics, USC-Union

William M. Graham

Owner, Graham's Flowers

Louis M. Jordan

President, Jordan's Ace Hardware, Inc.

Carl L. Mason

Chairman

Retired

Dwight V. Neese

President and Chief Executive Officer

Provident Community Bank

Philip C. Wilkins, DMD

Dentist

**Leadership Group
Provident Community Bank**

Henry G. Alexander, Jr.

Vice President

Union Region Commercial Relationship Manager

Carolyn H. Belue

Vice President

Operations Administration Manager

Brenda T. Billardello

Vice President

Marketing Director

Edward A. Brock

Senior Vice President

York Market Executive

Richard H. Flake

Executive Vice President

Chief Financial Officer

Lisa G. Morris

Vice President

Human Resource Manager

Dwight V. Neese

President

Chief Executive Officer

Mark F. Pack

Senior Vice President

Business Manager Program Director

Lori H. Patrick

Vice President

Union Market Executive

Susan D. Taylor

Vice President

Fairfield Market Executive

Jeffrey M. Thompson

Vice President

Laurens Market Executive

Lud W. Vaughn

Executive Vice President

Chief Credit Officer

Wanda J. Wells

Senior Vice President & Corporate Secretary

Shareholder Relations Officer

Corporate Information

Common Stock Information

Union Financial Bancshares, Inc.'s common stock is quoted on the Nasdaq National Market under the symbol UFBS. As of December 31, 2004, there were 757 shareholders of record and 1,957,989 shares of common stock issued and outstanding. The following table contains the range of high and low bid information of Union Financial's common stock as reported by the Nasdaq Stock Market and per share dividend as declared during each quarter of the last two calendar years. See Note 16 to the financial statements for information regarding certain limitations imposed on the Bank's ability to pay cash dividends to the holding company.

| <u>Calendar Year 2004</u> | <u>High</u> | <u>Low</u> | <u>Dividend</u> |
|---------------------------|-------------|------------|-----------------|
| Fourth Quarter | \$ 18.13 | \$ 16.40 | \$.100 |
| Third Quarter | \$ 17.12 | \$ 15.46 | \$.100 |
| Second Quarter | \$ 17.55 | \$ 16.74 | \$.100 |
| First Quarter | \$ 17.26 | \$ 16.68 | \$.100 |
| <u>Calendar Year 2003</u> | <u>High</u> | <u>Low</u> | <u>Dividend</u> |
| Fourth Quarter | \$ 18.29 | \$ 16.83 | \$.100 |
| Third Quarter | \$ 18.45 | \$ 16.75 | \$.100 |
| Second Quarter | \$ 17.19 | \$ 14.44 | \$.100 |
| First Quarter | \$ 15.85 | \$ 13.51 | \$.100 |

Dividend Reinvestment Plan

The Corporation has a dividend reinvestment program that allows shareholders to purchase additional shares with corporate dividends. Details of the program are outlined in the dividend reinvestment prospectus. To receive more information, please contact the Shareholder Relations Officer at the corporate address.

10-KSB Information

A copy of the Form 10-KSB filed with the Securities and Exchange Commission, will be furnished to shareholders, without charge, upon written request to the Corporate Secretary, Union Financial Bancshares, Inc., 203 West Main Street, Union, South Carolina 29379.

Annual Meeting of Shareholders

The Annual Meeting of Shareholders will convene at the Main Street Auditorium of the University of South Carolina, Union Campus, Union, South Carolina on April 20, 2005 at 2:00 p.m.

Additional Information

If you are receiving duplicate mailings of shareholder reports due to multiple accounts, we can consolidate the mailings without affecting your account registration. To do this, or for additional information, contact our Shareholder Relations Officer at the corporate address shown below.

Corporate Offices

203 West Main Street
Union, South Carolina 29379
(888) 427-9002

Transfer Agent

Registrar & Transfer Company
10 Commerce Drive
Cranford, New Jersey 07016
(800) 456-0596

Independent Registered Public Accounting Firm

Elliott Davis, LLC
200 East Broad Street
Greenville, SC 29601

Special Counsel

Muldoon Murphy & Aguggia LLP
5101 Wisconsin Avenue, N.W.
Washington, D.C. 20016

General Counsel

Nelson Mullins Riley & Scarborough
104 South Main Street, Suite 900
Greenville, South Carolina 29601

Shareholder Relations Officer

Wanda J. Wells
Union Financial Bancshares, Inc.
203 West Main Street
Union, SC 29379
(864) 429-1861

Website

www.providentonline.com

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Exhibit 21

Subsidiaries of Registrant

| | <u>Percentage Owned</u> | <u>Jurisdiction or State of Incorporation</u> |
|--|-----------------------------|---|
| Subsidiaries | | |
| Union Financial Statutory Trust I | 100% | Connecticut |
| Provident Community Bank | 100% | United States |
| Provident Financial Services, Inc. (1) | 100% | South Carolina |

(1) A wholly-owned subsidiary of Provident Community Bank.

Exhibit 23

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statement on Form S-8 pertaining to the 1995 Stock Option Plan and the 2001 Stock Option Plan of Union Financial Bancshares, Inc. and in the Post Effective Amendment No. 2 to the Registration Statement on Form S-3 (No. 333-35319) pertaining to the Dividend Reinvestment Plan of Union Financial Bancshares, Inc. of our report dated January 28, 2005, with respect to the consolidated financial statements of Union Financial Bancshares, Inc. and subsidiaries incorporated by reference in the Annual Report on Form 10-KSB for the year ended December 31, 2004.

/s/ Elliott Davis, LLC

March 21, 2005
Greenville, South Carolina

Exhibit 31(a)

CERTIFICATION

I, Dwight V. Neese, certify that:

1. I have reviewed this annual report on Form 10-KSB of Union Financial Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this

report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2005

/s/ Dwight V. Neese

Dwight V. Neese

President and Chief Executive Officer

Exhibit 31(b)

CERTIFICATION

I, Richard H. Flake, certify that:

1. I have reviewed this annual report on Form 10-KSB of Union Financial Bancshares, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2005

/s/ Richard H. Flake

Richard H. Flake
Chief Financial Officer

Exhibit 32

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADDED BY
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Union Financial Bancshares, Inc. (the "Company") on Form 10-KSB for the fiscal year ended December 31, 2004 as filed with the Securities and Exchange Commission (the "Report"), the undersigned certify, pursuant to 18 U.S.C. §1350, as added by Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of and for the period covered by the Report.

/s/ Dwight V. Neese

Dwight V. Neese
President and Chief Executive Officer

/s/ Richard H. Flake

Richard H. Flake
Chief Financial Officer

Date: March 21, 2005

End of Filing

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